S. HRG. 104–264

RESTRUCTURING HUD'S ASSISTED/INSURED MULTIFAMILY HOUSING PORTFOLIO

 RING

BEFORE THE

SUBCOMMITTEE ON HOUSING OPPORTUNITY AND COMMUNITY DEVELOPMENT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

ON

THE ADMINISTRATION'S PROPOSAL TO RESTORE "SECTION 8" RENTS TO MARKET RATES ON MULTIFAMILY PROPERTIES INSURED BY FHA

JUNE 15, 1995

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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RESTRUCTURING HUD'S ASSISTED/INSURED MULTIFAMILY HOUSING PORTFOLIO

THURSDAY, JUNE 15, 1995

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING OPPORTUNITY AND
COMMUNITY DEVELOPMENT,
Washington, DC.

The Subcommittee met at 9:30 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Connie Mack (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR CONNIE MACK

Senator MACK. First of all, good morning and thank you to all of you for coming this morning and participating in this discussion of HUD's mark-to-market proposal to restructure the FHA-insured multifamily housing portfolio that receives HUD project-based Section 8 assistance.

I realize now after personally trying to submerge myself in this issue for the last several weeks, it is incredibly complicated and has potential major ramifications. So I think this is an important hearing this morning. I want to try to conduct it in such a way that there is good dialog, because I think frankly we all can learn if we open up the dialog, and I will attempt to do that. It is not necessarily an easy thing to do, but again I welcome all of you and I appreciate your participation.

I am going to take a few moments to make an opening statement which I think will outline and express my feelings and concerns with respect to this issue, so if you will bear with me and then we will get to our first panel.

Restructuring this portfolio is critical because the huge financial costs required to provide Section 8 assistance, and because Section 8 assistance contracts on about 700,000 units are expiring between 1996 and the year 2002, because these properties are also insured by FHA, any changes to the rental subsidy could result in costs to the FHA Insurance Fund.

HUD and CBO estimate that on a 25-year present-value basis the cost of maintaining current policy on renewals would be about $80 billion.

We are facing the need to restructure this portfolio today because flaws in the HUD multifamily insurance and subsidy programs have allowed owners to receive more Federal dollars in rental subsidy than is necessary to maintain properties as decent and affordable rental housing.

About 75 percent of the so-called "newer assisted properties" have Section 8 rents that are above, often well above, market values. Also in some of the newer assisted cases properties have physically deteriorated to substandard conditions. HUD's strategy to date has been to limit losses to FHA's Insurance Funds by providing additional rental subsidies to properties at the expense of improving the housing quality for tenants in managing its future risks better.

Beginning in 1996 and moving into the next Century, the Section 8 contracts on many of these properties will expire. The current policy has been automatically to renew these contracts and to continue over-subsidizing some of these properties. The upcoming expiration of Section 8 contracts provides us an opportunity—an important opportunity—to end excessive subsidies.

The Administration has taken on this challenge by introducing a strategy called mark-to-market. This strategy would end excessive payments of direct rental subsidies to projects, force projects to compete in the marketplace, and promote tenant choice in obtaining housing. At the same time, HUD has recognized the importance of aggressively enforcing regulatory and contractual requirements which it has failed to do in the past.

I commend the Administration's attempt to address this issue. However, HUD's proposed solutions raise serious questions about the potential impact of this proposal on residents, their communities, and the financial markets. Among the questions we need to address are: the cost of mark-to-market. Which insured properties should be included in mark-to-market. HUD's ability to implement its proposal, given its resource limitations.

Official cost estimates of this proposal are based on HUD's data. I am very concerned about making decisions based on information that some believe may not present a complete, accurate, or current picture of HUD's multifamily insured portfolio or the market conditions that will apply where HUD attempts to implement mark-to-market.

Indeed, it has been estimated, at least by one source, that mark-to-market may cost nearly $84 billion versus the nearly $80 billion it will cost to maintain current policy. In short, I am concerned about our margin for error.

Compounding this uncertainty is the fact that we still do not know exactly how HUD's proposal is supposed to work. The proposal now looks different than it did when HUD first proposed it, and HUD has only recently developed, quote, "an operating framework" unquote, that consists of approaches called "reflector sales" and "joint ventures."

HUD in fact has stated that its operating framework was designed to, and I again quote, "elicit further analysis and discussion" end quote, within the housing industry because neither we nor HUD knows exactly how mark-to-market will work or its impact in individual markets.

It is difficult to know what the potential impact of the proposal will be on residents and communities, but I don't believe in maintaining the status quo because this concept of mark-to-market is fundamentally sound and necessary and we cannot go on providing excessive taxpayer subsidies for housing assistance. But the pro-

posal could lead to the displacement of large numbers of tenants and replacement of many current owners with an uncertain impact on the supply of affordable rental housing.

I know that HUD and others are concerned that failure to address mark-to-market immediately will cause uncertainty in housing and financial markets and raise the ultimate cost of the proposal. While I appreciate that concern and don't suggest undue delays in acting on the HUD proposal, I am also concerned that we get the policy right and avoid unintended consequences as well as unnecessary costs.

The goal of today's hearing is to try to better understand what mark-to-market is getting us into, and its potential cost in social policy implications. We intend to examine the HUD proposal, but I urge those who are critical of HUD's approach to present alternatives and suggestions of their own. We will start by examining the scope and magnitude of the HUD-Insured and Assisted Multifamily Housing Stock.

The first panel will consist of Susan Gaffney, Inspector General of HUD; and Jim Wells from the General Accounting Office.

Our second panel includes the HUD Assistant Secretary for Housing, Nicolas Retsinas, who is accompanied by Helen Dunlap, HUD's Deputy Assistant Secretary for Multifamily Housing; and three private-sector witnesses who have considerable knowledge and experience in the multifamily housing issues: Larry Dale from the National Housing Impact Division of Fannie Mae; David Smith from Recapitalization Advisors; and William Haynsworth from Boston Financial.

Again I want to thank all of the participants in this morning's hearing. Now I will turn to my colleague and Chairman of the Banking Committee, Senator D'Amato.

OPENING COMMENTS OF SENATOR ALFONSE M. D'AMATO

The CHAIRMAN. Thank you, Senator Mack.

I want to commend you for holding these hearings. I want to ask that my full statement be placed in the record as if read in its entirety.

Let me say, Chairman Mack, I commend you for holding these hearings. This is the fifth one, I note. The consequences of extending Section 8 Project-Based Assistance contracts is great, particularly since many of these units are over-subsidized.

HUD's mark-to-market proposal is an attempt to end the excessive subsidy payments. However, any restructuring of the multifamily portfolio must be made in the light of reality. Adjustments to these subsidies may cause some projects to go into default, which will cause financial losses to the FHA Insurance Fund.

HUD's multifamily proposal which was most recently outlined in its May 26 document called "The Operating Framework" has not been fully developed. I think it is imperative that we fully examine the ramifications of mark-to-market.

I have to tell you that I would hope that HUD takes the opportunity to meet the people who have been involved in the operation and in running some of these projects. I would hope that you get the chance, and particularly in the large areas of concentration, to get the views not just from the inside of the Beltway but out on

the byways of America and ascertain with a degree of definiteness, not just from friends who want to give you good opinions, but from people who know.

Now there are a number of people who are experts in this area. It seems to me that we would be making a grave error if we don't consult with them as it relates to the practicality of a plan that may appear on paper to be saving money but that in the final analysis may result in massive defaults, abandonment, and foreclosures, and a tremendous problem as it relates to the Federal Government then having to deal with the inadequacy of the FHA Fund.

I am telling you that I am so concerned and I believe you might very well imperil the FHA Fund if you are not careful in this mark-to-market. It is one thing to attempt controls and to do away with excessive subsidies. I am for that. It is another thing if you don't examine what the potential loss may be.

That is my caveat to you. I am telling you you better go slow on this and make sure it is done right. Let's not just undertake something to meet budget goals by plugging in numbers that later on will be disastrous.

So that is my suggestion, and I commend the Chairman for the manner in which he is approaching this very complex and very real problem that we have with all these Section 8's coming due.

It has been rampant and out of control. I do not blame this Administration. I would not suggest that. This has been a problem that has been building up over years. You are at the helm now. You are trying to do something. But I am saying, let's not just act for the simplicity sake of saying, well, we have plugged these numbers in and now we meet our budget goals that would push us into a situation which will result not only in a loss of dollars to the taxpayer and imperil the FHA, but I tell you you could hurt tens of thousands of people unintentionally—the families and the tenants.

Thank you, Mr. Chairman.

Senator MACK. I thank you for your comments and thank you for being here this morning. Believe me, what you expressed is of great concern to all of us. We will keep those thoughts in mind as we try to work our way through this.

At this point I will turn to Senator Bryan.

OPENING COMMENT OF SENATOR RICHARD H. BRYAN

Senator BRYAN. Mr. Chairman, let me shock everybody and say I am really here to hear the witnesses. I will put some opening comments in the record and ask that they be made a part of the record.

Senator MACK. I thank you.

Let us go ahead then with Ms. Gaffney.

OPENING STATEMENT OF SUSAN GAFFNEY INSPECTOR GENERAL, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT; ACCOMPANIED BY: CHRIS GREER, ASSISTANT INSPECTOR GENERAL FOR AUDIT WASHINGTON, DC

Ms. GAFFNEY. Thank you, Mr. Chairman.

I would like to touch on three issues this morning. The first is the dimensions of the portfolio we are proposing to mark-to-market. The second issue is whether we should end in part or totally Section 8 Project-Based Subsidies. Third, I would like to comment on the mark-to-market proposal that HUD has put forward.

First of all, my comment on the dimensions of the portfolio proposed for mark-to-market. You know very well that these are the bulk of the insured and assisted mortgages.

There is one component that is missing from this portfolio. It is the moderate rehabilitation insured and assisted mortgages. I would ask that you don't forget about that segment of the portfolio. With the history of the moderate rehabilitation program, clearly we should be including these properties in the proposal. I think the reason they have not been is just very simple, and it is bureaucratic: that the Administration of that program is not within FHA; it is within Public and Indian Housing. So we have just had a bureaucratic disconnect, but I ask you to keep that in mind as we go forward.

Senator MACK. What is the dollar amount of that?

Ms. GAFFNEY. I don't know. We think it is a very small number; probably only about 6,000.

Mr. GREER. 6,000 to 7,000 units.

Senator MACK. All right.

Ms. GAFFNEY. So it is small, but it is important given the history of the scandals.

With respect to project-based subsidies, the position of the Office of Inspector General is that we should be entirely out of this business. I think you probably are aware of the statistics, but let me go over some of them. With respect to the newer assisted properties, 75 percent of them are over-subsidized—clearly over-subsidized. With respect to the older assisted portfolios, the estimates are that 30 percent of them are in serious disrepair. With respect to the 221(d)(3) Older Assisted, we have had a claim rate of 39 percent. The loan-loss reserves for those properties are now set at 25 percent. With respect to the 236 Older Assisted Properties, we have had a 17.3 claim rate and the loan-loss reserves are now set at 27 percent.

Generally everyone is in agreement that the newer assisted properties are severely over-subsidized. There is some debate about the quality and condition of the older assisted properties, which are generally below market interest rates. I am giving you these statistics to show that portfolio is not in good shape.

The question is how we got here and why. I would like to give you our perspective. We got here because, one, HUD has over the years exhibited an inability to manage these properties well. They have exhibited an inability to service the mortgages, to do risk assessments, to move in early and prevent foreclosures; and as we proceed to decide what to do with that portfolio, we need to keep this history in mind because HUD's capacity is not going to improve. It is going to get worse very fast as the number of HUD employees is subject to being cut by a third or more.

The second factor that has led us to where we are is an absolute inability to control the costs of project-based subsidies. I would say that both HUD and the Congress have participated in this.

David Smith is today going to talk to you about his view of the condition of these properties. Whether he is right or wrong, the truth is that, with real estate, the condition today means nothing with respect to where you are in 5, or 10, or 15 years.

For instance, the older assisted multifamily properties started with relatively shallow interest rate subsidies. They did not have Section 8 Project-Based Subsidies. Now, fully 65 percent of the units in the older assisted inventory receive project-based subsidies.

The reason is that properties got in trouble. Every time they got in trouble, we became concerned about claims on the Insurance Fund; we became concerned about losing affordable housing; we became concerned about displacing people; and we stepped in and gave them more subsidy and more subsidy and more subsidy, so that now from zero we are up at 65 percent of the units being subsidized.

The third problem with these project-based subsidies is the premise that this is a private-sector program, and the private sector tends to be efficient and effective and we the Federal Government tend to be bungling and inept.

In fact, this is not a private-sector program because the owners in this program are insulated from virtually every private-sector motivation or discipline. They have very little equity in these projects. It is nonrecourse debt. They receive the monthly subsidies virtually no matter what they do, no matter what is happening to the project.

If this sounds negative toward the owners, I do not intend that. Obviously the Federal Government constructed this program. It was not the owners who did it. But no one should think that this is a private-sector operation that we have going.

The last thing that I want to talk to you about is perhaps the most important because no one else talks about it. Everybody talks about costs and displacing people and the condition of the units themselves, but there is something else we need to talk about, which is: That 98 percent of the people living in the newer assisted housing are low- or very low-income; and 94 percent of the people living in the older assisted property are low- or very low-income people.

Now, one of the problems we face is, we don't have good data on these properties and the neighborhood conditions, or even the finances of these properties. But I think we have all come to understand that, we should not be concentrating low- and very low-income people in one place.

Our goal is mixed income. That's not what we have here. We do not have authoritative data about the conditions of the neighborhoods and crime and the prospects for the people living in these properties, but I can tell you this: the OIG and HUD are now involved in something called "Operation Safe Home," which is trying to get Federal and local law enforcement involved in trying to solve the rampant problem of violent crime in public and assisted housing.

As I go from community to community talking to people—and particularly chiefs of police—what they say over and over again is: You think you have a problem in public housing? Project-Based

Section 8 is as bad or worse—which is not surprising, given the concentrations.

In public housing we know we have a violent crime problem, but the Congress has established programs to help us deal with that. We have the Drug Elimination Program. We have Social Services. We have counselling. We have the means—I don't know how well we are doing, but we have the means to go after the problems.

On these assisted properties, there are no means; there is no funding. We are acting as though this is private sector good real estate and we don't need to provide for all of those other social support costs. I would say to you, if you are going to stay in this business, you had better be prepared not just to maintain those properties but to do something for the people who are living in desperate situations.

If I were an owner, I would not be happy about what is happening, and I can understand that. I think the Federal Government has lived up to its bargain, but, nonetheless, I think some of the owners are facing real problems under the mark-to-market proposal.

I would urge you, though, if a compromise has to be found, that the compromise not be in the nature of maintaining this unhealthy alliance between HUD and owners that maintains a system which does not work to the best interests, I think, either of the taxpayers or the residents.

Finally, on the mark-to-market proposal, I would like to agree with what you have said, and also what Senator D'Amato has said.

We don't know enough to really talk about this. This proposal, in our judgment, is much better than the original proposal because the original proposal involved HUD's marking-to-market each one of these mortgages. HUD does not have the capability to do that. The advantage, from our perspective, of this recent proposal is that it has the market taking care of that, not really HUD. However, we have some big reservations.

One, as you have said, this is not a fully fleshed out proposal by any means. We don't even know what the proposal is in some respects. I also fear that we are not moving fast enough to get a fully developed proposal.

Second, we have real reservations about the provisions for elderly and disabled. I know that this is a very sensitive subject, but I don't understand why—if we are talking about doing something straight and right and disassociating project-based subsidies from these mortgages—why are we making special provisions for fully 50 percent of the residents. It simply flies in the face of the principle.

I would say to you, we can find other ways, and we should, to help the elderly and disabled so that they are not left to their own devices to find housing, which they would be terrified and ill-equipped to do.

There is a provision in this latest proposal for HUD's giving rehabilitation loans to some of these properties, and I would question that for the same reason. I mean, we should be cutting this, or not cutting it, and not trying to find some mix in the middle.

I have one proposal, and it is not very innovative. Since the implications of this are so enormous for the residents and for the tax-

payers, and since none of us is comfortable quite with what is before us, and we're not sure how we're going to get to a point where we are comfortable, why can't we convene a brain trust of people who could be working not just on one proposal, but working on alternative proposals and verifying the costs. This would be in addition to what Mr. D'Amato said, which is talking to the people out there who are involved—and I think FHA is in fact going to have some forums where they're going to be talking to owners and residents and managers.

There are people who have done this. We don't have just to limit ourselves to HUD and CBO and OMB. What about the people who lived through the RTC? Why didn't we call on them? Aren't there people on Wall Street who have done this kind of thing enough that we could bring them in and ask them to work for us?

So, that is my one suggestion.

Senator MACK. I think that is a good suggestion, and we may very well follow-up with some conversations with you about that. I appreciate that.

Mr. Wells.

OPENING STATEMENT OF JIM WELLS, ASSOCIATE DIRECTOR HOUSING AND COMMUNITY DEVELOPMENT ISSUES U.S. GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY: RICHARD A. HALE, ASSISTANT DIRECTOR WASHINGTON, DC

Mr. WELLS. Thank you, Mr. Chairman and Members of the Subcommittee.

If I could just pick up for a moment on one of your comments in your opening statement about how difficult this issue is, I was before this Senate body a couple of months ago talking about the difficulties of disposing of nuclear waste. Believe me, in preparing for this hearing there are some similarities in terms of difficulties.

[Laughter.]

That is one of the reasons I brought our Assistant Director with me, Rick Hale, who does most of our multifamily family work in GAO and is very familiar with the multifamily portfolio.

I will just quickly take a few minutes this morning to discuss how mark-to-market may work, and offer some of our observations.

HUD is basically asking for legislative approval to make some fundamental shifts in Federal housing policy.

What they want to do is make assisted housing more subject to market principles. What they want to do is reduce housing assistance costs. What they want to do is to save the Government billions of dollars.

While there are various groups in this town, as well as people here in this hearing room, that are going to have different opinions about whether HUD can accomplish any of this or all of this, or any one of these types of things, I think there is very little disagreement that the existing assisted multifamily portfolio is troubled.

As we testified earlier this year before your Subcommittee, Mr. Chairman, both HUD and the Congress have a particularly vexing set of problems to deal with regarding the approximately 2 million

privately-owned and managed rental units that HUD insures and/or subsidizes in some manner.

From the early 1960's through the mid-1980's FHA has operated at least a dozen different types of combinations of programs, combinations of mortgage insurance, direct loans, and subsidy programs.

As HUD has acknowledged itself, many of these programs were flawed not only in their design but in their operations. So contracts, as a result, have been signed that provide for subsidies—and these contracts have been signed for 15, 20, up to 40 years—so today it is a reality that HUD faces a tidal wave of expiring Section 8 contracts over the next 10 years that will truly put billions of dollars at stake.

In May HUD estimated that its costs to renew the existing contracts for Section 8 rental subsidies will grow from about $5 billion in fiscal year 1996 to about $14 billion in 1998. Clearly financially the situation raises a lot of serious questions about budget issues and perhaps argues loudly for a need for constructive change, and therefore is the reason for this hearing today.

In the existing contracts that are out there, the Federal Government is in fact over-subsidizing properties for as much as twice what they're worth. Elsewhere in other programs HUD has under-subsidized the properties by holding rent subsidies far below market rates that may have resulted in poor physical conditions.

Some of the work we did last year, for example, uncovered a two-bedroom unit that HUD subsidizes that is in very poor condition, distressed condition, in Las Vegas, Nevada that rents for $820, which is over twice the $380 rent that is charged just down the street for a much nicer unit that is in an unsubsidized property. These kinds of things are difficult to understand. To HUD's credit, it is recognizing that they have these problems and is attempting to address them.

HUD's mark-to-market proposal, if I could take just one minute to briefly summarize, is intended to address a lot of the flaws that I just talked about by eliminating project-based assistance in the vast majority of the properties that are also insured by FHA.

As these contracts expire, HUD proposes that they will apply the mark-to-market principles, and they will cover approximately 9,000 properties which entail about 900,000 units, which is about 50 percent of the portfolio out there. So their first attempt at this proposal is getting at about 50 percent of the portfolio that is out there.

HUD very clearly has stated that they do not propose to abrogate existing Section 8 contracts. They are proposing that the residents that are living in the units that receive present project-based assistance, that they would continue to receive this assistance on a tenant-based basis when the project-based assistance is terminated.

From a mortgage perspective the proposal would establish mechanisms for adjusting the project mortgages downward to allow such properties to compete in the commercial marketplace without assistance.

According to HUD, this adjustment would help the properties to get their income and expenses in line. This adjustment could be

done in various ways, and they have offered a couple of proposals, but as of today HUD is still unsure exactly how they are going to use these mechanisms, and which mechanisms are going to be used.

For example, a decision still has not been made, and they need assistance in determining which is best. Do you deal with the situation before default? Or do you deal with it after default?

The efforts of marking-to-market, depending on what is decided, will vary depending on whether the property is over-valued or whether the property is under-valued as of today.

For those properties that exceed market value, marking-to-market would lower the mortgage debt, thereby allowing lower rents and lower subsidy costs. For a property whose rents are currently below market value like they are in a number of the older assisted properties, marking-to-market would allow the property rents to increase, but it also increases the Government's subsidy cost.

HUD recognizes through its proposals that some of these properties that are out there today will not make a go of it. In a sense, even if we mark-to-market and we mark the property mortgages down to zero, these properties would still not make a go of it. In those cases, HUD may be proposing to use alternative resolution measures like including demolition of the property, and maybe a subsequent attempt at sale of the land to a third party such as a nonprofit organization or a local entity, perhaps even for a dollar.

Yes, for these types of properties that no one will want, it is very clear that they will be demolished and these properties will no longer be available in the inventory.

HUD is estimating that if enacted, while it will cost money in the short run, its proposal will save the Government billions of dollars in the long run. Pay me now, or pay me later.

It is difficult for us to accurately forecast the cost and the savings associated with this proposal. While HUD's proposal does in fact, or probably will result in substantial reductions in immediate Section 8 subsidy costs, it will also trigger billions of dollars in claims against the FHA Insurance Fund. HUD does in fact probably deserve some credit for attempting to estimate these costs. However, its current estimates are based on a number of assumptions that may or may not prove accurate as we get further along.

Accordingly, in our view these estimates may be subject to considerable error. Therefore, I guess the old adage "buyer beware" is certainly applicable in evaluating this proposal.

The Congress also faces a number of key issues in trying to determine whether HUD's proposal represents in fact the best approach. I just quickly want to list the seven key issues that need to be addressed: (1) The processes that they are going to use to restructure the debt, the mortgages. (2) The speed with which we are implementing mark-to-market. (3) The extent to which the Government should finance project rehabilitation. (4) The question of whether the loans should be sold without FHA insurance in the future. (5) The level of protection and assistance the Government should provide to the tenants after the project-based subsidies are discontinued. (6) The question of how to improve the usefulness of tenant-based assistance as the way they want to go. (7) The extent

to which projects that currently have assisted rents that are below market rents should be included in today's proposal?

These are tough questions that will need answers before we get into deciding whether HUD should get the legislative authority that it needs.

Let me say quickly in closing that there is no doubt that the HUD proposal involves very complex issues and has potentially far ranging effects. What they are asking for is a basic fundamental shift in Federal housing policy, and any type of shift like that should take time, and it should be studied.

It is clear that we all want to make sure that we have the proper programmatic tools available to you; you want a smooth transition; you want to minimize the disruption that will occur to people; you want to minimize uncertainty. But as some housing experts caution, you may want to take time to work all these out.

I agree with you, Mr. Chairman, in your opening statement where you made the statement that it is very important that we get the policy right. We would agree with you there. But on the other hand, a word of caution, that in reality, time does not wait when you deal with a dollar-and-cents issue coming into play.

It is important that these issues be resolved as quickly as possible, since delays are truly likely to lead to project disinvestment, financial uncertainty, and ultimately to high costs to the Government.

Owners, the people on Wall Street, the lenders, the investors, these are the people who are going to make some immediate decisions, probably even as we speak today, to protect their interests in terms of where they stand on some of these points. Whatever decisions they choose to make may impact very negatively on our desire to make positive changes to save money and to help people.

Mr. Chairman, this concludes my prepared remarks and we will be glad to answer any questions.

Thank you.

Senator MACK. Thank you, very much.

We are joined by Senator Bond who is a Member of this Subcommittee, but who is also Chairman of the Subcommittee on Appropriations for VA/HUD. Did you have an opening statement you would like to make?

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Mr. Chairman, thank you. I do.

I very much appreciate your calling this hearing, because we do have some very definite time deadlines. We have to produce an appropriations bill some time this fiscal year. It will be easier when we get the numbers to work with, but I apologize for arriving late. This is the White House Conference on Small Business.

I had to be on a program, and I had to follow the Speaker of the House and the Majority Leader, a humbling position I have not been in since I first began my political career and was at a county fair having to follow a kid with a trained dog act and a beauty queen who played the piano and sang.

[Laughter.]

I felt somewhat anticlimactic, and I have to leave in just a few moments.

The CHAIRMAN. The dog?
Senator BOND. Pardon?
The CHAIRMAN. The dog did this?
Senator BOND. Well, it was a trained dog.
The CHAIRMAN. It played the piano?
[Laughter.]
Senator BOND. No, no, that's different. That's Senator Exon's story.
Senator BRYAN. Mr. Chairman, the Senator is not suggesting that there is an analogy with us and the experience he had at the county fair, I hope?
[Laughter.]
Senator BOND. If my good friend from Nevada listened carefully, I would say it was following the Speaker and the Majority Leader, and I have to leave again.

This is a subject that my staff and I have spent a good deal of time on, and I have a longer statement that I do wish to supply for the record. We will have questions for the record, as well, and my apologies to the witnesses. I will not be able to be here for the full Q and A, but I do want to support and re-state my support for the premise that HUD does need to restructure its Section 8 Project-Based portfolio to get some handle on the Section 8 program-to-market value.

I have had opportunities over the year to review and discuss the HUD mark-to-market proposal with HUD, and with other experts, and we have had Committee hearings. Unfortunately we have found the mark-to-market proposal seems to be work in progress.

Every time we ask more questions, the complexities grow. But we do know that the appropriations are going to be constrained. We have to balance the budget. We have an obligation to find cost-effective ways to provide and maintain affordable housing, and we need to reduce the cost of Section 8 assistance.

I emphasize that we are going to have to understand the cost, the savings, and the consequences of the mark-to-market proposal. I am afraid this whole issue is a compendium of "C's in the mark-to-market area: Considerable Cost; Confusion; Complexity; Concern and Controversy; in contrast, there is Clearly no Consensus on the solution."

[Laughter.]

This does not bode well for expeditious Congressional action despite the agreement that reform is needed.

Let me raise something I believe Mrs. Gaffney has already raised: Underpinning the Department's proposal there appear to be several fundamental assumptions.

First, that project-based assistance is bad and should be replaced with tenant-based vouchers. Second, that HUD is incapable of directly or indirectly managing a multifamily inventory restructuring so that a rigid, purely market-driven standard should be the sole determinant of how properties are handled.

The tremendous diversity of types and forms of housing, the nature of subsidy commitments, and the differing interests they serve, especially in neighborhood stabilization and community development, can only be addressed after FHA is out of the picture.

I would like to challenge the witnesses today to address these assumptions. I am troubled by some of the potential consequences. For example, we have the case of preservation eligible properties, as Mr. Wells pointed out, who currently charge rents averaging only 85 percent of market rent even after we acknowledge the deferred maintenance needs in these projects.

Marking-to-market could require that the rents be raised, not lowered, and that the Federal rental subsidy costs be increased. With respect to the assumption against project-based assistance, I find it curious that the Department has not made a complaint about the quality or success of Section 202 elderly and the handicapped housing which utilizes the 20-year project-based Section 8, or the State-financed multifamily developments, or the low-income housing tax credit project.

All of these questions, Mr. Chairman, are going to have to be resolved. Again, I appreciate very much the work of this Subcommittee in getting into these issues. I thank the witnesses for their very enlightening and, if not troubling, testimony on this subject.

Senator MACK. Thank you, Senator Bond.

We will proceed now to questions.

The first area—and I want you both, if you would, to respond to it—in trying to make an estimate about what the costs might be associated with these proposals, I am concerned again about the quality of data. Do we have the right kind of data? To be more specific, what is your current opinion of HUD's Automated Data Systems? How do these problems affect one's ability to accurately estimate the potential costs and social impact of mark-to-market?

Mr. WELLS. I will jump in first to say that the data is not very good. Clearly, HUD does not have data as good as we would like it to have.

Just take rents, for instance, a very critical piece of information they need to know about what is going on. A lot of the information that they are basing their proposal on is truly 1989 data that was collected and published in 1993—very critical information, but somewhat old. They are in the process of contracting to get new information.

Condition of properties: A lot of information needs are not there to know what condition the properties are in.

Financial data has improved over the years. We are encouraged that we are getting better financial numbers than we have ever gotten out of HUD, but I don't want HUD to get off the hook too easily because, quite frankly, from a good management perspective HUD does not do a very good job in having good data to make good decisions on what should be done.

Senator MACK. Yes. But I am sure you didn't go through an exhaustive statement of the various pieces of data that you would want, but it seems to me that equally important, if not more important, is the context in which one looks at all of those important let's say project data of that is what is happening in that particular market in that particular community.

Mr. WELLS. In that "particular community," within that two blocks, what are the rents? They don't know.

Senator MACK. Ms. Gaffney.

Ms. GAFFNEY. Well, I agree with that. One of the reasons HUD is not proposing——

Senator MACK. Get the microphone a little closer.

Ms. GAFFNEY. One of the reasons that HUD is not proposing to go at this on a development-by-development basis is because they in fact do not have the data in a form that is usable on that basis. To some extent, they don't have the kind of contextual data that you would need. The problem becomes——

Senator MACK. Can I ask you a question before you go into the problem? What you are saying is that HUD recognizes the inadequacy of the data. Therefore, there ought to be another approach that they use in order to go through the process of marking-to-market.

The concern I have is that, in essence, what you are saying is that we are going to take those who are experts in this area and we are going to work in the market. The market is going to make those determinations. But does that not kind of say that then we are going to go into this almost blind with respect to an estimate of what either the cost or benefit is going to be as a result of doing it?

Ms. GAFFNEY. Yes. HUD has done some very substantial mortgage sales over the last few months, and it is my understanding that what they are doing is projecting their experience from those mortgage sales further into the portfolio.

Senator MACK. Now as I understand it, though, it would be very difficult to make the case that those mortgage sales would accurately represent the rest of the portfolio. Is that not accurate?

Ms. GAFFNEY. Yes, I think that is correct.

But you know, we, the OIG, have been coming here for years telling you about the deficiencies in HUD's data systems; and they're working on it, and it is taking years. The dilemma is: I don't see that they can get to where you and I would like them to be in terms of data——

Senator MACK. In time to make the decisions that we are dealing with.

Ms. GAFFNEY. That is the dilemma that I think we face.

Chris—I neglected to introduce Chris Greer who is the Assistant Inspector General for Audit.

Chris, do you have a view?

Mr. GREER. I think my view would be that there is a lot of great data at HUD. It is just not displayed in the context that you were mentioning. For example, the mortgage sale that just happened in the southeast section of the country, tremendous data was gathered and put up on the Internet as a matter of fact. I think that had a lot to do with the values that were reflected in the end. But that was a tremendous effort, and that is not the everyday world.

So the data is probably there in the field offices; it just needs to be gathered and put together in a different fashion.

Senator MACK. I am going to ask one further question, and then I am going to turn to my colleagues.

I hear the warning that I think probably both of you expressed that you don't have a lot of time to deal with this. But on the other hand, you know, it may be just human nature that when we are being asked to make some decisions here with, at this point, totally

inadequate information with a whole series of various properties out there ranging from those who couldn't make it even if they didn't have a mortgage, to those that would make it without any assistance at all in all kinds of conditions.

Is there any way that we could develop some kind of pilot projects as we try to work through different kinds of properties out there to get a sense of how the market is going to react to these various proposals? Or do we just not have the time to do that? Can either one of you or both of you——

Ms. GAFFNEY. I don't know if there is an easy answer. Of course we could do pilots. The question is: What happens? How does the market react to that? What do we do about the 125,000 units that are coming up for Section 8 contract renewal in 1996?

It raises a series of other questions. I think I would like to say to you that I don't think we have gone far enough even in our conceptual thinking about this. I think we need to come up with some alternatives, instead of just waiting for HUD to reveal some more of its proposal, and then we all criticize that.

It seems to me that we should be engaging other people who know about this kind of thing to think and to come forward with proposals.

Senator MACK. Very good.

Senator D'Amato.

The CHAIRMAN. Well, Mr. Chairman, I am just going to make an observation based on what Ms. Gaffney just touched on.

We are flying blind into a very dangerous situation, not only economically as it relates to what will happen with the FHA, but this will be a catastrophe. Let me tell you something. The speculators out there will pick our bones dry. You will have some incredible problems. Not to mention the potential for serious social/public policy questions of people being placed out on the street, or just having no management in some of these facilities.

People are going to walk away. You have got to be careful. Let's be constructive. You have got some of the smartest, best, most talented real estate operators in the country in areas who know how to run projects, who make money, and who do good jobs, and who can tell you where you can bring about some savings.

What we do not need is a big forum where we bring everybody in and have them all talking. You could have a list of 10 of the best, most successful in New York, in Boston, in your Metropolitan areas where most of these projects are, or a good number of them, down in Texas and Dallas, et cetera, and get hold of them and bring them in and ask them: How do you go about this?

Then if you need to start some pilot projects—but to just immerse ourselves because we have got to meet budget figures, in something that really potentially could be terribly embarrassing and a great faux pas is something I would not recommend. You just do not have the information, and I do not think we are going about it the right way.

You can find out who the 10 top realtors are. Bring them in, people with experience, sit down with them and start thinking in constructive areas. That is not my job. If I start to do it, why then I am going to be suspect and you are going to have a why was it this

one, and that one, and the other one, but it is the job of the Administration to start doing that.

Now let me also say that if you are going to bring in—and this is not to deprecate any one of the great investment houses who have got smart minds, but they are just looking for a new way to sell a different product, et cetera, be careful.

I am not referring to any of the witnesses today. But speak to the hands-on people who understand. I could mention half a dozen names here of people, and they are successful, and they have made money, and they run good, solid projects. Contact them. Sit down with them.

You are not going to get that from some bright-eyed, bushy tailed fellow who has worked out that there is an overpayment of so much, and we can sell these securities—they're not going to give you that.

I am not saying you don't need investment houses to look at it, but get those people out in the field who know it. It seems to me that then you can begin to try to manage some of these projects. But to open the whole thing up to this, you are going to have a catastrophe. I believe that you are headed for a very real crisis.

So go slow and begin to bring in people and start some pilot projects, I think, Senator Mack—why don't we see some? Also you've got a great wealth of experience—and by the way, they've got a tiger by the tail, but they're beginning to manage it. Get the Fannie Mae people who have done a heck of a job, and the Freddie Mac people, and begin to sit down with them and get some of their experiences in dealing with some of these properties if there's a co-relationship.

I'm not necessarily speaking to this panel, but I'm speaking to the housing people like Mr. Retsinas. I know you're trying to do the best job you can. Again I say, this is not the fault of this Administration. I mean, this has built up over the years. This is an inherited situation, but be careful on it. That's all.

I thank the Chairman again for being so patient and spending his time in looking into this in a careful, thoughtful manner and providing the oversight that is so necessary.

Thank you.

Senator MACK. Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman.

This is pretty discouraging. Nobody can defend the status quo based on the litany of accounts in the indictment that Ms. Gaffney lays before us.

Comment, if you will, on some data that we have been provided with that indicates that if we go to this mark-to-market plan as proposed, we actually increase our net cost because the amount of the insurance claims will exceed the savings of the Section 8 payments. Is that correct or incorrect?

Ms. GAFFNEY. There are two different schools of cost. One is the HUD school, and the other is the CBO school. Both of them essentially say the same thing—which is, that the costs up front from claims are going to be very heavy. The long-term costs will decrease because the claims will decrease and you will be out of the subsidy business.

There is, I think, a $4 billion difference in the CBO versus the HUD estimates. I am going to be very honest with you. I have heard the explanation of that difference, and I don't understand it.

Do you, Chris?

Mr. GREER. No, I don't.

Ms. GAFFNEY. But can I say——

Senator BRYAN. Please. I mean, I think we're looking for kind of some guidance. I am not defending the status quo, but we have been given some CBO data that indicates that you're looking at a substantial addition of $7.2 billion in insurance costs over the next 7 years.

Ms. GAFFNEY. That is 25 years. Over 25 years.

Can I just make one observation that bothers me about this situation?

Senator BRYAN. Yes.

Ms. GAFFNEY. That is, to go back to what Chairman Mack and Senator D'Amato were saying, it seems to me—and maybe I'm wrong about this—that this discussion is proceeding simultaneously at two levels. One is a policy level about what we should do with Section 8 Project-Based Subsidies, whether we should continue them or not; whether we should be terribly concerned about displacing people; whether we should be concerned about the owners being left high and dry.

There are a series of policy questions which I am not sure we have agreement on, but we are jumping to what is a kind of mechanistic issue. Once you have agreement on those policy issues, I think you then ask how do you get there. That is what mark-to-market is. It is the mechanism.

My concern is that we do not yet have—and perhaps I am wrong about this—we do not yet have agreement on the guiding principles. If we had guiding principles that we agreed on, then it seems to me it shouldn't be that tough to bring in a group of people and say, OK, now you figure out how to do this.

Senator BRYAN. You are suggesting we have the cart before the horse.

Ms. GAFFNEY. Yes.

Senator BRYAN. Mr. Wells, your comment leads into the next observation. You are indicating that you think if we go to the mark-to-market that we are going to see a number of these units, and perhaps some of them should, but simply there are going to be defaults, claims that they're economically not viable, and that we are in effect going to bulldoze—that's my word not yours—but I think I read the plain meaning of your language.

My question is this:

Again, I don't ask this from the standpoint of whether we ought to save that structure at all costs, but what are the implications for the tenants? In other words, this whole concept is that we would give everybody a voucher and that's fine, but does not the voucher presuppose that there are choices the tenants can make?

If that is not there, then the underlying premise, it strikes me, is flawed even though—and I want to be clear—nobody defends the present system and the ineptitude of the management under many Administrations.

I would like your comment.

Mr. WELLS. There are some major unknowns. I would like Rick Hale to address that. I would also like him to tie it back into your cost question, too, because we are very much concerned about the cost issue, too.

Senator BRYAN. It just strikes me that we could embark upon urban chaos here in attempting to reform something that really needs to be changed, but do we have the understanding?

If you would comment, Mr. Wells or Mr. Hale, on my basic questions: What about the tenants? Where are they going to live if we bulldoze the old structure? Is there a place for them?

Mr. WELLS. What about the tenants? Who are the tenants? There are numbers in this town that run the gamut from there will be 45,000 units or people who are displaced; there will be 60,000; there will be 200,000. They don't know for sure what the actual displacement will be.

Senator BRYAN. But they are very poor people. We do know that. I would agree with Ms. Gaffney that we have got very, very poor people all congregated together and that has been kind of a disaster. That is my perception.

Mr. HALE. Senator Bryan, if I could, I would like to try to tie this back to the first question you asked.

I think this all goes back to what the Chairman was saying about the difficulty of forecasting what is really going to happen with these properties.

There are a number of differences between CBO's estimates of costs and HUD's estimates, but a fundamental difference is how many of these properties are actually going to default and require restructuring.

HUD would say for the new-construction sub rehab projects, which are the ones that have the very high rents, that only 40 percent would need restructuring or would go into default. CBO is estimating that it would be 65 percent of the projects. That is a fundamental difference.

Obviously, the more that default the higher the claims that are going to result and the higher the costs to the Government. The fact is that nobody really knows with the existing information how many will in fact default.

Senator BRYAN. Do you have a number that you can look to in your crystal ball?

Mr. HALE. I tell you, Senator Bryan, the difficulty here is really you are trying to use some sort of administrative judgment for what the market is ultimately going to decide.

Let me just go back to the loan sale for a minute. I think it is really very instructive. HUD did sell off earlier this year about a billion dollars in loans. They were on nonsubsidized projects, not on the subsidized projects we are dealing with now.

It was a big success in that they got a return of $700 million, but conventional wisdom, before those loans were sold, they were only worth $300 million.

I think that shows you the kinds of variations we are talking about in figuring out administratively what a property is actually going to be worth to somebody in the market.

Senator BRYAN. That goes back to the comment the Chairman makes about the absence of a data base.

Mr. Chairman, thank you.

Ms. GAFFNEY. Senator, might I try to respond to your question?

Senator BRYAN. It is up to the Chairman. I would be delighted to hear what you have to say.

Senator MACK. Sure. Go ahead. Hold it briefly, if you could, and then we will go to Senator Sarbanes.

Ms. GAFFNEY. Oh, I'm sorry—just about the tenants and what happens to the tenants.

Senator BRYAN. Yes. I am concerned about them.

Ms. GAFFNEY. And is there a supply of affordable housing.

All the data that we have seen indicate that on a nationwide basis there is an adequate supply of affordable housing, that these people could use vouchers; but it is also clearly the case that in particular markets there is not, and they could not and cannot use vouchers.

You will see in the HUD plan that there is—in the Operating Plan—a sentence or two about they're going to have to figure out what to do about such markets. So it is another ill-defined aspect.

Senator MACK. Senator Sarbanes.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Well, it is not very "ill defined." I don't see that it helps us very much for you to tell us about efficient and affordable housing on a nationwide basis because people don't get housed on a "nationwide" basis. You get housed on a community basis—at best, on a community-wide basis, and perhaps not even that. So the fact that there is a lot of excess housing in State X does not help the people in State Y who need housing. I don't understand the import of that comment, frankly.

Ms. GAFFNEY. I'm sorry, sir. I didn't mean to say that. Obviously, it matters where the person is looking for a home whether there is a supply of affordable housing.

Senator SARBANES. I want to pursue this matter with you, Ms. Gaffney. I am quite bothered by the testimony at the hearing and I just want to put Senator Bryan's question to you again.

I don't agree with your division that the mark-to-market is simply mechanistic, since obviously we are dealing with limited resources. If in fact there is a significant cost difference, we need to know that.

Our ability to agree on the concepts which you said had to be arrived at first is not unrelated to the mechanisms if the mechanisms are cost questions, since we have a shortage of resources, or limited resources. Now would the mark-to-market be more costly, or less costly?

Senator Bryan put the question on the mark-to-market, and you save on outlay, but then you may precipitate projects into default and you would have to pay out of the fund. Is that essentially the problem?

Ms. GAFFNEY. That's correct.

Senator SARBANES. Well, I want that problem analyzed. I don't want you to make a policy judgment. I don't want you to get into the inadequate concepts; I just want an analysis about the problem so I get some basis of what the factual choices are that I have. What is the analysis on the mark-to-market proposal as to whether

it will cost us less money or more money? In either event, by what order of magnitude?

Ms. GAFFNEY. HUD's analysis shows that it will over 25 years save money.

Senator SARBANES. How much?

Mr. GREER. It is about $3 or $4 billion.

Senator SARBANES. Three or four billion?

Mr. GREER. Then you get involved in present value, and those numbers over 25 years get pretty complicated.

Senator SARBANES. Well, can you lay it out for us?

Ms. GAFFNEY. I don't have that data with me, but HUD has them and we can give them to you.

Mr. HALE. If I could try to answer that, Senator Sarbanes, it is——

Senator SARBANES. I'm sorry, Mr. Hale, I don't know who you are.

Mr. HALE. I work with GAO.

It is a very complicated question to answer.

Senator SARBANES. I understand it is complicated. That is why we keep asking you these questions and keep trying to get some analysis out of you that is going to start clarifying the landscape.

Mr. HALE. Let me try to tell you what HUD's analysis shows——

Senator SARBANES. Senator Mack and I agree it is complicated. We said that to one another yesterday.

[Laughter.]

Tell me something else that I don't know.

Mr. HALE. I will tell you what HUD is estimating. Actually HUD uses two baselines to estimate mark-to-market against. One is a baseline that follows basically the conventions that are used in preparing the President's budget.

They also have a second baseline which they judge to be a more realistic baseline of the status quo which generally assumes there will be a higher level of claims and higher subsidy costs than those that are assumed in the President's baseline.

Compared to this, quote/unquote "more realistic baseline," HUD is projecting that the mark-to-market proposal will save about $8 billion, including both claims and discretionary costs or subsidy costs, over 25 years on a net present-value basis. CBO, in comparison, says that over 25 years that the proposal could cost $4 billion more.

Why the differences? It's differences in estimates of how many claims will occur; what the costs of those claims will be. It's also a difference in estimates of what the subsidy costs will be over 25 years, based in part on a policy decision of whether or not you want to provide the people that are receiving this assistance, the tenant-based assistance, what's called a shopper's incentive.

This basically says that if the fair market rent is $500 a month and I move into a unit that is $400 a month, can I keep that extra $100 to encourage me to try to really look for a place that is less expensive?

HUD assumes no shopper's incentive. CBO assumes a full shopper's incentive.

The fundamental thing—and I don't really mean to get back to saying this is confusing, but basically what we are trying to do in coming up with these estimates is to look 25 years into the future.

Senator SARBANES. Fine. That leads to the next question I want to ask, because at least this is giving me something.

What you are telling us is that under one analysis they save $8 billion over 25 years, taking into account all costs.

Mr. HALE. Exactly.

Senator SARBANES. The benefits from the lower subsidy and the offset from the charge to the fund.

Mr. HALE. Yes, sir.

Senator SARBANES. OK. The CBO estimate is not that you gain $8 billion, but that you lose $4 billion. So there is a difference of $12 billion. Both are over a 25-year period.

Mr. HALE. That's correct.

Senator SARBANES. Now what do those analyses show say over the first 10 years of the 25 year period? You are just about to make the point that it is difficult to do the 25-year. Do me a 10-year projection on the basis of that analysis, or a 5-year—a 5-year and a 10-year projection. What does that show?

Mr. HALE. I was going to say, I don't have the CBO numbers committed to memory, but the HUD numbers basically show that it is going to be more costly over the first 5 years.

Primarily I think—and it depends on the baseline—but again, probably $3 billion, if I'm remembering correctly, basically because you are going to have most of the claims against the Insurance Fund in earlier years; whereas the discretionary savings in assistance costs are going to occur over a longer period of time. You are not going to really appreciate the full benefit of those until the out-years as you restructure more and more of the new construction/substantial rehabilitation contracts because, again, those are the ones where we are now paying subsidy costs that are higher than what you might expect if we're providing tenant-based assistance.

So in the short run I think anybody would agree it is going to be more costly because you are going to have more claims in earlier years than you are going to have savings in housing subsidy costs.

Senator SARBANES. What was the amount?

Mr. HALE. For the realistic baseline, my recollection is that it is in the neighborhood of $3.5 billion under the HUD estimate, and I would have to check for you the CBO estimate but we would be happy to provide that to you.

[The following information was subsequently submitted for the record:]

CBO's June 2, 1995 estimate is that mark-to-market would cost about $8.3 billion more during the first 7 years than the current policy baseline. In comparison, HUD's May 30, 1995 estimate shows that mark-to-market would cost $2.7 billion more than HUD's "realistic" estimate of baseline costs during the first 5 years and $2.4 billion more than the "realistic" baseline over the first 7 years. Compared to HUD's "official" baseline, mark-to-market would cost $3.7 billion more over 5 years and $4.7 billion more over 7 years. All of these estimates take into account both housing assistance and insurance costs.

COSTS OF MARK-TO-MARKET: CBO VS. HUD ESTIMATES

[Dollars in Billions]

FHA Fund Costs (Mandatory)	CBO Estimate	HUD Estimate	Difference
Current Policy:			
Over 7 years (1996–2002)	$0.2	$0.7	+$0.5
Over 25 years (present value)	0.6	2.7	+ 2.1
Mark-to-Market:			
Over 7 years (1996–2002)	$7.4	$4.8	−$2.6
Over 25 years (present value)	5.6	4.1	− 1.5
Net Cost—Mark-to-Market vs. Current Policy:			
Over 7 years (1996–2002)	$7.2	$4.1	−$3.1
Over 25 years (present value)	5.0	1.4	− 3.6

EXPLANATION OF DIFFERENCES:

** HUD's estimates about the cost of maintaining the status quo are more pessimistic than CBO's. HUD argues that in the absence of more aggressive intervention, FHA claims will rise sharply over time as the insured stock ages and owner disinvestment accelerates.

** HUD's mark-to-market estimates are more optimistic than CBO's, because HUD assumes a greater number of FHA-insured projects will adjust to market discipline *without* the need for debt restructuring (and insurance claim). This difference is most pronounced in the category of Section 8 NC/SR projects, where CBO projects a claims rate of 65 percent vs. HUD's estimate of only 40 percent.

COSTS OF MARK-TO-MARKET: CBO VS. HUD ESTIMATES

[Dollars in Billions]

Subsidy Costs (Discretionary)	CBO Estimate	HUD Estimate	Difference
Current Policy:			
Over 7 years (1996–2002)	$40.0	$42.2	+$2.2
Over 25 years (present value)	79.2	82.2	+ 3.0
Mark-to-Market:			
Over 7 years (1996–2002)	$41.1	$40.5	−$0.6
Over 25 years (present value)	78.2	72.2	− 6.0
Net Cost—Mark-to-Market vs. Current Policy:			
Over 7 years (1996–2002)	$ 1.1	−$ 1.7	−$2.8
Over 25 years (present value)	− 1.0	− 10.0	− 9.0

EXPLANATION OF DIFFERENCES:

** As with Mandatory costs discussed earlier, HUD's estimates are more pessimistic than CBO's about the cost of maintaining the status quo. HUD argues that progressively greater amounts of discretionary spending will be required (LMSA, Flexible Subsidy, Section 8 PD) to maintain the aging subsidized stock under a status quo approach.

** The largest single difference between HUD and CBO estimates is the projected cost of subsidies in the post mark-to-market period. CBO had assumed that tenants who remain in the older assisted projects would receive a large "shopping incentive" (i.e., a cash debate for choosing less expensive housing). HUD has since clarified with CBO that this assumption was incorrect. Virtually all savings generated by mark-to-market will accrue to the Department, either in the form of lower Section 8 certificate costs or higher Section 236 IRP recaptures.

Senator MACK. I would propose at this time to go on to the next panel.

Again, I thank all of you for your participation this morning. [Pause.]

Good morning, and I welcome the second panel.

As we have already determined, this is a complicated issue. Senator Sarbanes and I just conferred again and we are sticking to our earlier commitment.

[Laughter.]

Senator MACK. We look forward now to your testimony. Mr. Retsinas, if you will go ahead and make your statement.

OPENING STATEMENT OF NICOLAS P. RETSINAS ASSISTANT SECRETARY FOR HOUSING, FEDERAL HOUSING COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT; ACCOMPANIED BY: HELEN DUNLAP, DEPUTY ASSISTANT SECRETARY FOR MULTIFAMILY HOUSING, WASHINGTON, DC

Mr. RETSINAS. Thank you, Mr. Chairman, and Members of the Subcommittee.

I would concur in that assessment. It is also very hard. I would also concur in an assessment that one of your colleagues made as I caught the end of it. It is our issue. When I say "our issue," because it is an issue that has emerged over time. I want to thank you, Mr. Chairman, for your willingness to deal with this issue head on. Complicated issues and hard issues are often left off the table and put on the side. This is one, I think we would all agree, we cannot do so.

I would like to submit for the record a full written testimony with a series of appendices and charts and forms and the like, but I would like to focus on context, focus on basic principles, and focus on where we are in the process, and then hopefully we can engage in some further discussion on that.

Let me start, if I could, with context. The problem we are trying to fix really began almost 25 years ago. It began at a time when this country, this Nation, the Administration and the Congress decided that one way of stimulating the production of affordable housing for low-income tenants was to use two different tools.

One tool was the tool of rent subsidies—project-based assistance is the word we use today; and the other tool was the multifamily insurance program. Historically those tools had not been joined, but beginning through the 1970's and over time we began to see an interface of those two particular tools. As a result, the status here in 1995 is about 75 percent of the FHA multifamily credit is supported by rental subsidies of one form or another.

Second, if you look at those subsidies and we turn the microscope on the subsidies, about the same percentage—75 percent of those subsidies—are over market in our newer assisted portfolio. So we have a phenomenon where at first blush the layman would question why are we paying in subsidies more than the market? If the market can support a certain rent, why is the Federal Government having to pay more than that rent?

Lots of reasons for how historically that happened, but the reality today is the reason we do it in large measure is, if we don't do it then it will be the Federal Government that will be liable through its insurance program.

So in a sense what we have done over time is we have been—and I use the word advisedly, but descriptively, not pejoratively—

we have been forced to continue to pay these subsidies to prop up that insurance. That is where we have been.

The difficulty is, we could keep doing that. The problem is that our current forecasts—and again, our current forecast is the subsidies that would be required to continue to sustain that insurance and these developments over time begin to escalate at a phenomenal pace.

It is pretty clear—we can make a whole series of assumptions—but it is pretty clear, if those subsidies continued on the current path they would literally swallow and consume the budget that is available to the Department. It is further exacerbated by the reality of the context which we are all in, the context of deficit reduction and balancing the budget.

Even under normal circumstances, without pressure to balance the budget the subsidies grow at a very rapid pace, but particularly given what I believe is the clearly now bipartisan reality of a reduced Federal budget, the subsidies that would be required to sustain these projects to honor that insurance are literally not achievable over the long term.

As a matter of fact, I think there is—and I want to be again careful with words—but I honestly believe from my perspective that there is inevitability to this concept of marking-to-market. The concept being in essence a proposal that says we are better served if the real estate is valued at its true rent as opposed to an artificially subsidized rent. Because if the subsidies aren't sustainable over time, inevitability—you reach that point.

We have put together some charts which I want to bring to your attention. Why now? Well, I have given the general reason, which is the budget pressures, but also I think there are some opportunities. If you could turn your attention to the chart—and let me introduce, if I could, my colleague Helen Dunlap who is our Deputy Assistant Secretary for Multifamily Housing.

If you look at that chart, you can see the contracts that begin to expire over the next 20, 25 years. Many of these contracts were 15- and 20-year contracts that were begun in the 1970's. As you can see, there is a spike in those expirations over the next 2 or 3 years.

Let me add that, even if you adopt mark-to-market as we are proposing, we will continue to have project-based assistance for the next 20 years because some of those contracts, as you see, go into the year 2020. But clearly there is an opportunity over the next several years to take advantage of this.

I now want to turn your attention, if I could, to a second chart—which is: What are we talking about? Which projects are we talking about? First, I would differentiate, if I could, assisted housing from public housing. This is privately-owned assisted housing.

As you can see, there are about 4 million households in differing kinds of assisted housing. If you look at the pie chart, look at the yellow. There are about 1.7 million households in projects that really have two characteristics: either they are insured and/or they are assisted through rent subsidies. Our mark-to-market proposal really takes on one slice, one big slice of that pie. Those projects have two characteristics. One, they are insured. Two, they get rental assistance. If they only have one of those characteristics, they are not

covered by mark-to-market. It is only when you have that interface of insurance and subsidy.

Now let's break up that pie, if we could, into three smaller slices. Mark-to-market affects the so-called Section 8 new construction or substantial rehabilitation projects. These are projects that began in the 1970's, through the 1970's into the early 1980's until the program stopped new originations.

It also affects older projects under the so-called Section 236, 221(d)(3) which over time we appended to those projects certain rental assistance and rental subsidies.

The other category, the other 100,000 units are essentially projects that began as insured only but over time in order to, quote, "save those projects," we allocated to them certain additional rental subsidies. So we are talking about 900,000 households and about 9,000 properties.

Let me, if I could, point you to the top of that chart just for a moment to talk about what is not covered. We are not talking, for example, about marking-to-market the 202, which is the senior citizens' housing, or the 811, disabled housing. They are a different kind of housing, a different kind of context, a different kind of population. They are not covered by that proposal.

We are also not talking about applying mark-to-market the projects that only get insurance, which is the third slice, or just get the rental assistance, which is the second slice. Different kind of situation.

We are not talking about the full portfolio of HUD-assisted properties, just those properties that have insurance and have subsidies.

OK, let me just make sure I'm along with the chart here.

Senator Sarbanes, you asked an excellent question about what does this really cost? Does it save money or not save money?

One of my frustrations—in coming to Washington—is that sometimes the way people keep score here and keep track of the budget is different than I might normally think of "budget." I like to think of budget as most of us do: How much is coming in? How much is going out? Does one exceed the other?

What I would like to do is just spend a minute talking about a purely economic analysis of the savings, and then we can translate that into budget scoring, and mandatory and discretionary, and all the words that we use.

If you look at this chart for a second, the dotted line shows the cost of the status quo—and I am going to translate these into numbers in a second—but as you can see, over time with the escalating subsidies, the cost is substantial.

The mark-to-market is the firm line. It shows in the beginning there is an added cost because there are claims on the insurance fund, but over time you get savings from reduced subsidy costs.

If we can turn to the next chart, Helen, we can put some numbers on this.

Now let me give all the appropriate qualifications. This is unadjusted for inflation. We are not present-valuing. We have all those numbers, but I just wanted to look at the next 25 years and find out what things cost. Does it make sense to do or not to?

If you look at the status quo column, that is continuing the current practice of keeping subsidies and credit linked. The newer units, again referring to the Section 8 new construction/substantial rehabilitation. We estimate that over the next 25 years it would cost about $130 billion to maintain the subsidies that pay for those units. We estimate for the older units, the 236, the 221(d)(3), that it would cost about $84 billion.

We also expect, despite our able management, that there are going to be insurance claims during that period. Those insurance claims, and the cost to the fund of managing those foreclosed properties, will be about $8 billion. Again, I am doing simple arithmetic. I am just adding the numbers for each of the 25 years and doing the multiplication.

For mark-to-market, the primary savings come of course from the reduction in the subsidies; from the $130 billion to the $97 billion, or a savings of $33 billion.

On the surface it would appear that there are no savings with the older inventory. On a pure cash basis, that's correct. But I would submit that our proposal is an opportunity to provide some rehabilitation and recapitalization of that stock.

So if you look at that older assisted stock, it is a different stock with mark-to-market than it is under the current status quo; but I am not going to submit to you that there are cash savings. I think the savings there are in the investment in the real estate.

Similarly, we believe over time there are savings in the FHA Insurance Fund, because we think that over time this will reduce over a 25-year period the claims and the holding costs to the Fund. Again, I don't want to oversimplify an issue that is so complex, but I want to give you some real numbers, if I could.

Let's talk for a second, if we could, about mark-to-market in a little more detail. Again just let me restate for the record what mark-to-market is.

Senator MACK. You do have limited time.

Mr. RETSINAS. All right. I will restate very quickly. It is a resetting of the debt to take into account the true market and not artificial subsidies. We believe there are different ways to do that. We certainly hear the cautions about doing it prudently.

I would submit, Mr. Chairman and Members of the Subcommittee, that we have already embarked on mark-to-market. Last year under the leadership of Senator Sarbanes; this Subcommittee gave the Department some additional flexibility for example in the disposition of the HUD-owned properties.

As you recall, that flexibility said that prior to the law that passed last year we could only sell properties if subsidies were attached to them. We ran into a problem because we didn't have the subsidies.

You gave us some discretion to sell properties without subsidies. Well, in some ways that is marking-to-market because we did not sell the property at an inflated cost that took into account the subsidies. We sold it at a true cost that assumed there were not subsidies. So again in a sense we are already doing mark-to-market.

Again, and during the Q and A I can go into some more detail, but we are really talking about two different approaches here. One is to reset and mark-to-market this debt after default; though our

preferred option is to do it on the second column, proactively. As you and Senator D'Amato among others suggested, we are currently working with people in the industry to find out how we can do this proactively.

Let me just conclude and thank you for letting me go over, that this is hard, this is complicated, but it's also something that we must address because to do otherwise I think risks a more serious damage not only to portfolio but also to the taxpayer.

Thank you, Mr. Chairman.

Senator SARBANES. Mr. Chairman, could I just clarify one thing?

Senator MACK. Sure.

Senator SARBANES. My understanding of what we did last year was, previously under the law you had provided in effect subsidies for all units even if all units were not receiving a subsidy, and that is the requirement we lifted off of you. But you still had to provide a subsidy for all units that were receiving a subsidy. Is that not correct?

Mr. RETSINAS. That is true. You gave us some discretion in certain conditions not to do that, but that is correct. I was really talking about the former case, Senator, where you did relieve that subsidy requirement.

Senator SARBANES. Yes, but that was really a subsidy in theory not in practice.

Mr. RETSINAS. Well, it was. Every year——

Senator SARBANES. In terms of there were not tenants receiving it. But if—I forget what the requirements were, but if you then disposed of it you had to dispose of it on the assumption that every unit would receive a subsidy, which is completely divorced from the reality.

Mr. RETSINAS. Right. Therefore that affected the—in those few—we did have some subsidies dollars, but in those cases therefore that inflated the cost of that property. That was my only point, Senator.

Senator SARBANES. Thank you, Mr. Chairman.

Senator MACK. Mr. Dale.

OPENING STATEMENT OF LARRY H. DALE, EXECUTIVE DIRECTOR, NATIONAL HOUSING IMPACT DIVISION FANNIE MAE, WASHINGTON, DC

Mr. DALE. Thank you, Senator.

Good morning. Thank you, Mr. Chairman and Members of the Subcommittee. My name is Larry Dale. I am the Executive Director of Fannie Mae's Housing Impact Division. We are responsible in that division for coordinating our trillion dollar Showing America a New Home commitment, as well as for our multifamily programs.

One of the commitments under that is to do $50 billion of multifamily housing between now and the end of the decade. We are well on our way toward that goal.

At the moment we have a $29 billion portfolio of multifamily assets, both loans we own, loans we've credit-enhanced, and securities we've issued. We have $3.9 billion of that in FHA-insured mortgage loans.

The at-risk multifamily portfolio is performing very well with a 1.1 percent serious delinquency rate.

In spite of the size—the largest privately-held portfolio of multifamily assets in the United States—the first thing I guess in some ways I am pleased to report to the Subcommittee is that we have relatively little economic interest in the mark-to-market proposals that are being discussed today and in that FHA inventory. This is the result of two factors:

First, the FHA assets that we owned are by and large insured, so as long as the insurance is not abrogated, we will be paid off if there is a problem with the real estate. Second, where we have financed subsidies from the Government in any form, whether they are HUD subsidies or other agency subsidies, we have tended to conform our financing terms with the contractual terms of those subsidies. So, unless the contracts are abrogated, we would not expect to suffer any loss.

On the other hand, we have a tremendous interest in the multifamily marketplace. The fact that most renters are below the median income—this tends to be a relatively modest income population—which we feel makes rental housing very important to the society at large. It is in all of our interests that the rental community be well served.

We have an interest in the partners and the people who have dedicated their lives to providing affordable housing, and we don't want them to be put out of business or otherwise driven away from providing affordable housing.

We also have an interest in assuring that the investment community continues to be attracted to affordable housing.

So we have an interest in the area, that it be done and done well, but one solution or another is not likely to affect Fannie Mae in any significant way economically.

We have taken the approach that if we are going to move directionally in the direction of mark-to-market, what advice, counsel, wisdom, and focus could Fannie Mae provide that might be of assistance to the Subcommittee, to the Administration, and to others which would make that move in the best possible way?

I think there are mark-to-market approaches that could be disastrous for owners, for residents, for the Government. They could be very costly.

There are potentially other approaches that could work rather well and might be a vast improvement financially, to residents, and to the existing owners.

So mark-to-market could cover a variety of sins. We have tried to give our focus here to thinking about what are the areas that we really need to pay attention to and get right if this movement is to be as successful as possible.

Senator SARBANES. I think that you are telling us that the mechanistic way you do it may well affect whether you realize the concept?

Mr. DALE. Yes. That's right. We have focused on five areas.

First of all, vouchers. There is a heavy dependence upon vouchers. As I think we all know, and several comments earlier this morning suggested, vouchers don't work perfectly in today's world.

We need, if we are going to move to a heavier reliance on some sort of certificate or voucher, to make sure that they work very well; that they are broadly portable; that they don't result in dis-

locations in certain marketplaces; that they provide flexibility not only to encourage good shopping but also to let people buy a little bit more house for their family if they feel they can afford it and handle that rental burden.

We need to make sure that we don't have a take one/take all provision in vouchers which essentially discourages any owner from taking any voucher, because if they take one they'll have to take everyone presented.

In fact, we might want to go so far as to think of safe harbors. So that if an owner has some percentage of their units already rented to voucher holders, the owner can decline to take any more so as to avoid over-concentration in the property.

We want to make vouchers work as efficiently and as effectively as possible so that the owners are encouraged to make them available in the broadest possible rental community to avoid the problems of concentration.

The second area is this whole issue of Project-Based Subsidies. We have discussed this morning a couple of instances where Project-Based Subsidies are probably appropriate. It may be a property that was specially designed for the disabled. It may be a property in an Empowerment Zone which has very little value but is part of a turnaround effort where the Project-Based Subsidies really need to stay there.

The conversation has been going on for a long time, but we have yet to precisely define where to keep Project-Based Subsidies in place and where not to. It seems to me that this is an important policy consideration and decision to be made.

A third area is the mechanism itself. We agree completely with, I think, the Subcommittee, and I know with HUD, that you need some form of self-executing mechanism that establishes value. We cannot rely on a governmental staff to negotiate case by case workouts and restructurings. That will be a disaster. It will be very costly and take a long time.

We need to make sure that we value the property correctly. There is a great deal of emphasis in some of the existing proposals about the mortgage. I understand that, because that is HUD's interest at the moment, in the mortgage.

But as all of you know, the mortgage should not equal the value of the property, and it usually doesn't. The property usually has some equity in it. One might think of approaches that value the real estate, not just the mortgage.

We need to make sure that we don't come up with a structure that places good current owners and operators at a disadvantage.

Because of the fourth point, which I will mention in a moment, tax policy could place existing owners at a disadvantage if you go to a straight mortgage sale. Obviously, we want to place existing poor owners and operators at a terrible disadvantage, and that is built into most of the proposals that we have seen, but we have to make sure that that works.

The fourth area is tax and housing policy. Tax and affordable housing policy in this country have been inextricably intertwined for decades. They are still inextricably intertwined.

The idea that one can proceed with a major housing policy revision without having the necessary relationship to tax policy just

will not work. The consequences are likely to be expensive and unintended. I realize it is not this Subcommittee's purview to write tax policy, but somehow the mechanism to coordinate mark-to-market approach, what it means for existing owners, with tax policy is imperative if this is going to be done successfully and not have some very poor, unintended consequences.

Finally, any investor in multifamily or commercial income property that has a problem with the real estate, which is clearly what HUD as insurer of these mortgages is facing after a mark-to-market situation, that essentially says that I will not participate in financing the solution is tying one hand behind their back, or maybe both hands behind their back and is likely to lose a lot more money than if they are willing to be a participant in the financing of the solution.

It seems to me that this is also one way to integrate a response with tax policy. If you provide financing for certain good operators, that is somewhat better than financing that is available to third parties, you might be able to integrate your response in an effective way.

I guess finally I would agree, with many others, that this is an extremely critical problem that needs deliberate focus and step-by-step attention. I think the phasing that we saw in one of these charts gives us an opportunity to retain some flexibility in a response; to go forward, but to go forward with some flexibility, because surely 2 years from now some adjustments will need to be made.

No one-size-fits-all solution is going to occur. I think you all recognize that, and I think HUD recognizes that.

I agree that the knowledge that has been presented here today to the Subcommittee and the experience that HUD is encouraging and bringing together will help refine these proposals in a way that recognizes the many different dimensions of the issue and allows us to move forward prudently.

Senator MACK. Thank you.

Mr. Smith.

OPENING STATEMENT OF DAVID A. SMITH, PRESIDENT RECAPITALIZATION ADVISORS, INC., BOSTON, MA

Mr. SMITH. Senator Mack, Senator Sarbanes, thank you for inviting me here. My name is David Smith. I run a little company in Boston called Recapitalization Advisors. All we do is the finance of existing affordable housing. In that, we have a data base of about 800 projects in various HUD programs.

I have some lengthy prepared remarks which I would ask be included in the record, but I would like more or less to discard them and attempt to answer the specific questions that you, Senator Sarbanes, raised; and you, Senator Mack, have raised early on, which are: What are we trying to do? What is the way to do it best?

If I could—I unfortunately had to fly down here myself, so I do not have a company assistant to handle this—I am going to start by working off of HUD's charts.

I want to draw your attention first and foremost to the fact that you don't have one portfolio. You have two portfolios. You have an

older-assisted portfolio, and you have a newer-assisted portfolio, and they are more different than they are alike.

The older assisted portfolio comes up for renewal now. The principal reason is because that portfolio has 3- to 5-year what are called Loan Management Set Aside (LMSA) contracts.

The newer assisted portfolio comes up dramatically starting in 1998, and later.

Significantly, the two portfolios are very different in a whole bunch of material respects. If I can indulge your imagination, pretend this is an aerial view of your back garden which was planted by previous Congresses over time.

This [indicating] is the older assisted portfolio. This [indicating] is the newer assisted portfolio. These are ranked by rent. So these have the lowest current rent, and these [indicating] have the highest current rent. Down the middle is the market, this ephemeral quality we are looking for.

Most of the older assisted portfolio has rents that are below market today. Technicians disagree about how much below market and how many are below market, but most of them are below market today. There is a good piece of evidence for that. Only two-thirds of the people who live in this portfolio now receive Section 8. Therefore, the remaining one-third are people who pay all the rent themselves.

Now they are only staying there because they like it. If they had a better alternative, they would move. So we have implied market evidence for a significant subset of this portfolio, and that implied market evidence is telling us that these are below market rent.

By contrast, the newer assisted portfolio—and again remember the older ones come up first; the newer ones come up later—the newer assisted portfolio is largely above market. The reason it is above market is it was constructed that way. It was put in difficult areas. It was built to a higher standard than the housing that surrounded it, and the contractual provisions in the rent structure had an unintended consequence of causing the rents to rise above market.

Most of them are up above market, and all of them receive Section 8. But half of them, as you heard earlier this morning, are elderly and disabled tenants. So if there is a single point that I would like to make in this presentation, it is simply this: One size does not fit all. You need a segmented strategy.

If I can go into the older assisted portfolio for a second, we chose to break it down—not being part of a large organization, I can say more or less whatever I want—we break it down into seven categories ranked, again, from the best to the worst. These [charts] are in the materials.

At the top are projects that are so nice and so well located that to preserve them costs you significantly more money than you can afford. Somehow they should be allowed to prepay and escape. At the bottom are fatally flawed projects—poorly built, poorly managed, in a location that has suffered some sort of economic meltdown—they must be culled somehow.

In between—and I want to focus your attention, Senator Sarbanes in particular, to this upper part of this chart—are good

projects. Some of them could prepay if the Federal Government restored the right to do so, the so-called "preservation inventory."

Some of them [indicating] can raise their rents today within their existing constraints, but not necessarily enough to prepay. A big chunk of them [indicating] are floating in equilibrium. Then we get into the subsidy-dependent and the troubled part of the inventory [indicating].

Now I completely agree with HUD's objectives. Cut rents on those that are above market. Get rid of the bad projects. Work out the troubled ones. Write down the debt. But I do question whether it is cost-effective for the Federal Government to voucher all of these residents, which means raise rents immediately, which is a cost with no corresponding savings, and deregulate them entirely.

I submit that for some of them you don't need to do anything; and for some of them there is a cheaper way to preserve them. This is where the preservation inventory comes in.

So if I can skip to the last chart—and I hope this is not too complicated—I think what you do is you segment your portfolio and ask a series of questions: Is the current rent above market? If it is not, you're getting a bargain. Why are you getting a bargain? Because you contracted for it. You negotiated with a private owner 15 or 20 years ago and you made a deal, and there is some bargain element left in the deal.

How much bargain element is left varies.

Is the project in need of some renovation, as we go down this chart? Maybe it is. Maybe we have to add some renovation in. Mr. Retsinas suggested that you need to rehab the older assisted stock. Maybe you do.

I don't think, by the way, that the older assisted stock is as troubled as Ms. Gaffney and the Inspector General's office suggested it is. I think simply that it is somewhat older and tireder than it needs to be. You could work within the existing regulatory structure and make it better.

If it is such a good project that the owner has a contractual right to opt out—the prepayment inventory—decide whether it is cheaper to keep him or let him go. If it is cheaper to let him go, let him go. If it is cheaper to keep him, pay him.

These projects are the best of the stock. They are the cheapest. They are in general the best located. They have the lowest Section 8 component in them, and they have rents below the market.

So while I absolutely agree with Ms. Gaffney, who said earlier it is hard to predict 25 years into the future, I think that within this particular group of the inventory you can look at that and say this is good stuff; it is hard to imagine it getting bad.

On the other side, if rents are above the market, you must cut the debt somehow. HUD is struggling right now with the question: How do you cut the debt? Who are the parties to that transaction? How are the market forces brought to bear?

That is a continuing dialog which, to echo what Senator D'Amato said awhile ago, we believe needs to be conducted between Government and the outside constituencies affected—the resident community, the owner-manager community, the financial community.

Once you have restructured the debt, can you pay the mortgage? Is there some amount of recovery?

The reason this is relevant, Senator Sarbanes, is because if you simply put into default only those projects that will be unable to pay their debt when you reduce it to market, you will put into default about 4,000 projects and you will trigger about $12 billion in FHA insurance claims over a 5- to 7-year period, but if it is done properly you will recover $4 billion in reconstituted mortgages.

Now those are neither CBO's or GAO's nor OIG's nor HUD's estimates; those are our estimates based on a portfolio of 400 properties that we extrapolated into the HUD portfolio as accurately as we could, and I would like if possible to put on the record afterwards the analysis which we did and presented to previous committees.

Mr. SMITH. If the project can't pay any rent—I want to draw your attention to one last point, and then I will finish up—there are good projects in bad neighborhoods whose sole crime, if indeed it is one, is that they are the best thing in a tough place, and they have zero ability to pay current debt service when you bring them down to true market.

Some of them are high-rise elderlies in rural areas. Some of them are family projects that are the best thing in an otherwise disinvesting area.

Do you say to the people who live there: You must move because we can no longer afford to keep this project open? Or do you say to those folks: We think you are part of the anchor of the neighborhood and we want to keep you?

In conclusion, I suggest there are three policy questions that the Congress must answer.

First, how much rent are you prepared to pay to house low-income people? No one is arguing for the status quo. The baseline is not status quo. Perhaps it is in a budget sense, but in reality it is not status quo.

Going forward, re-upping, are you prepared to pay rent based on the metropolitan market, which says to people you will live in the less attractive parts of town; local market, based on the neighborhood; something higher based on specific circumstances; or are you saying, "I want to pay as little as I can in order to get good housing?"

Second question: Once you've decided how much rent you want to pay, do you want to property base it or tenant base it?

That is a different question. It is an optional question. You can answer it differently for different parts of the portfolio—and you heard some witnesses earlier today talk about that.

Third question: To the extent that you have continuing regulation—and you heard HUD say that you are going to have continuing regulation, and if you have vouchers you have to regulate the vouchers—who do you think should do it? Current HUD? A new FHA corporation? What I would call public partners, such as State and local agencies? Or private contractors such as asset managers and folks like that?

If you the Congress can answer those three questions, then we the technicians can figure out the optimal way to do it.

Thank you, very much.

Senator MACK. Thank you, Mr. Smith.

Mr. Haynsworth.

OPENING STATEMENT OF WILLIAM E. HAYNSWORTH SENIOR VICE PRESIDENT, THE BOSTON FINANCIAL GROUP BOSTON, MA

Mr. HAYNSWORTH. Mr. Chairman, Members of the Subcommittee: Thank you for giving me the opportunity to share my views on HUD's mark-to-market proposal.

I am a Senior Vice President of Boston Financial, which is a national real estate investment firm founded in 1969. For the past 25 years the firm has focused its efforts in the multifamily housing industry. We currently provide asset management or property management services for more than 240 properties containing more than 30,000 apartment units which receive project-based Section 8 subsidies.

We also represent more than 36,000 investor-owners who invested in these properties. At Boston Financial I am primarily responsible for the structuring of real estate investments and the acquisition of new projects.

Prior to joining the company in 1977, I served as Acting Executive Director and General Counsel of the Massachusetts Housing Finance Agency.

We look forward to working with HUD on its mission to improve cost effectiveness and quality of its operations and programs.

We agree with certain of the core drivers of mark-to-market—mainly that the cost-effectiveness of housing programs will be improved by adding greater market incentives. However, we also believe that great care needs to be given before dismantling programs that currently support about 800,000 apartment units.

Boston Financial is primarily an investment and property management firm. We believe that the cooperation of owner-investors is critical to the overall success of the transition to mark-to-market.

I will focus my comments today on two issues which are of great importance to owner-investors and therefore to the successful implementation of mark-to-market. No. 1, Congress should ensure that debt restructuring proposed in mark-to-market not result in a taxable invent to owner-investors. No. 2, HUD should flexibly address the special needs of decent, well-maintained, affordable housing properties in particularly difficult areas, and other people have referred to that problem as well here.

Now a key assumption underlying mark-to-market is that the private sector will play an important role in its implementation. Boston Financial represents thousands of owners who invested over the past three decades in these properties in reliance upon the Government's commitment to its programs. These programs work. Properties were developed and billions of dollars of private capital was invested in reliance upon the Federal Government's commitment to its programs.

We believe that the Department will seriously undermine its restructuring effort if it does not give adequate consideration to its current partners. An issue which has not received sufficient attention in the mark-to-market debate is the tax impact on current owner-investors as a result of the proposed mortgage restructurings.

Debt forgiven by a lender is generally treated as taxable income to the owner. HUD is not proposing amendments to the Tax Code

citing the potential for unintended consequences. Failure to deal with this issue is likely to result in a lack of cooperation by owner-investors in the mark-to-market transition with resultant unnecessary delays, litigation, and disinvestment.

Boston Financial believes that Congress must act to ensure that proposed debt restructurings will not result in a taxable event.

I would like to point out a couple of projects that we happen to be the general partner of and we manage, and the effect that mark-to-market may have on them.

One of them is known as Glenfield Apartments. We believe that that can make a successful transition to mark-to-market, and actually we think mark-to-market if properly structured can work quite well and is a good answer to many of the projects that we are talking about. But again we are talking about how you do it as opposed to the current proposal.

Glenfield is a 104-unit garden-style apartment, Section 8 project based, located in a town in South Carolina, a small town in South Carolina. It was built in 1981 with a HUD-insured mortgage and about $800,000 in equity contributed from 10 individual investors.

The property is located in a modest neighborhood near both residential and commercial properties. Market rents in the Glenfield area are well below Section 8 rents. This is largely because Glenfield is much better housing than most of its neighbors. It is not luxurious, but it is well maintained and in good condition.

Replacing the property's current project-based Section 8 subsidies with tenant-based assistance pegged to current market rents we estimate would reduce the property's revenues by approximately $200,000 a year. With these reduced revenues, Glenfield would only be able to support a mortgage of approximately $320,000 based on debt service, coverage assumptions, certain interest rate assumptions.

Senator MACK. When you say it is a $200,000 decline——

Mr. HAYNSWORTH. Right.

Senator MACK. What is the overall revenue?

Mr. HAYNSWORTH. Well, right now the overall revenue on Glenfield is $580,000.

Senator MACK. The present mortgage?

Mr. HAYNSWORTH. The present mortgage is $2.4 million.

Senator MACK. You go from $2.4 million to $325,000?

Mr. HAYNSWORTH. Yes, because you have no offset. You get down and we're talking about, as Larry pointed out, we're talking about mortgages' values, and mortgages are a function of, in the private marketplace, of debt service coverages and that sort of thing.

Senator MACK. I'm just curious, and maybe we shouldn't go into this, but if it was $500,000 in revenues and $2 million in mortgage?

Mr. HAYNSWORTH. $2.4 million.

Senator MACK. It is almost 5 to 1? Why wouldn't the same ratio apply if you were at $325,000?

Mr. HAYNSWORTH. I'm not sure I understand the question, except if you cut off $200,000 of revenues, then that means that you only have, in this example, let's say $30,000 of net operating income; whereas you had $230,000 net operating income prior to that time.

Senator MACK. It took me a moment but I finally made it.

Mr. HAYNSWORTH. We recommend that HUD and its agents and partners work cooperatively with lenders and owners in advance of the expiration of Section 8 contracts to achieve the main goals of mark-to-market: properties operating efficiently as a result of the exposure to market incentives.

If all parties work together, the mortgage loan can be reduced to a level that the new rents can support so there's no need for default and disinvestment on the part of the owners. The owners will have an incentive to continue to maintain their property and operate efficiently, and that occupancy and reduced expenses will translate into cash returns. In other words, market incentives will be working.

There is one major catch here, however. Under current tax laws, the $2.1 million writedown of Glenfield's debt create paper income for investors who would thereby incur a huge tax—a large tax liability of nearly $200,000. Mark-to-market would provide no cash with which to pay these bills. To gain the cooperation of investors and owners for an orderly restructuring, these consequences must be addressed.

Investors will generally be unwilling to cooperate in a process that requires them to write large checks, especially since the checks do nothing to enhance the value of their investment.

Another group of properties which need special handling to survive a mark-to-market transition are represented by a 200-unit Section 8 property located in a town in Florida. We believe that this property, if it were to lose its project-based Section 8, would have difficulty retaining tenants, fall into disrepair, and ultimately be lost from the housing stock. This property is one of the few well-maintained structures in the area, and it is a safe place to live relative to other properties in the area.

However, the market is in a very distressed neighborhood where crime and drugs are constant concerns. In this particular case, the fair market rents are much higher than the Section 8 rents. If you give tenants vouchers in this particular project, many of them, if they have a choice, will probably leave, and we have no idea what the ultimate result will be but we feel that in the market place people who are bidding, if you are having a bidding process or trying to work something like this out, will really value the mortgage at zero in this particular case.

Again, it will have no value and we feel that the property ultimately will have to be either abandoned, destroyed, or what have you. You are losing some good housing stock in a distressed neighborhood. That is the dilemma that we are facing in a property like this.

We do want to give tenants—I think their policy is wise that gives tenants maximum ability and mobility, but by the same token you are creating a particular problem in this area which may be the one nice property in a particularly distressed neighborhood.

To avoid this type of risk, we recommend that in cases like this if HUD has flexibility and exercises the flexibility so judgment can be used to decide whether or not it makes sense to remain project-based assistance instead of going to all tenant-based assistance.

Thank you.

Senator MACK. Thank you.

I don't want to put anybody on the spot here, but I think it might be helpful to maybe hear where you all agree and/or disagree.

I might jump the two ends of the table to start the discussion.

In listening to Mr. Smith's comments, where do you kind of take issue, Mr. Retsinas, and where do you find some common ground here?

Mr. RETSINAS. Let me start, if I could, Senator with the common ground. Again I'm not going to talk about the numbers, per se, but let's talk about the concepts and the principles for a second.

I take common ground I think with all members of the panel here. I think I heard, and they will obviously correct me if I say otherwise, I think I heard from all of them that there is a fundamental recognition that the status quo is not sustainable.

There is a fundamental recognition that some form—and I'll use the word again advisedly—some form of mark-to-market is really the only way to escape the status quo. So I think there is a common agreement with that.

I do have a disagreement with Mr. Smith on the assessment of the older assisted inventory and the kinds of assistance it needs. He referred to the comments from the earlier panel, and I think I was closer to their judgment.

I think where I have a fundamental disagreement with a couple of the panelists today is the notion of who best could make the judgment of whether post mark-to-market project-based assistance is the way to go.

The gentlemen here, and I certainly respect all of them, and they and their colleagues have been invited to participate with us in the planning, but I would submit, Mr. Chairman that judgment is best made at that local level.

As you know, parallel to our mark-to-market proposal is the proposal to create a Housing Certificate Fund. In that proposal we allow that local community at its option to use that certificate as project-based assistance. For example, the project that Mr. Haynsworth was referring to, if in fact that project were important to the community and as he describes it it appears that it would be, then that local community could in fact use that assistance as project-based assistance.

We would not prohibit the use of project-based assistance, but we would not from Washington require it. So I think that is a point of disagreement, perhaps.

Senator MACK. Mr. Smith, did you want to comment?

Mr. Haynsworth, you might want to comment, too, as well.

Mr. HAYNSWORTH. Well, you know, I do think that—I don't necessarily disagree that if a local entity can determine to make this a project-based assistance type of project that I have a disagreement on that.

Senator MACK. OK. Good. Mr. Smith.

Mr. SMITH. I guess I would start, as my friend Mr. Retsinas did, with the common ground. The status quo is not sustainable. Reducing above-market rents has to be done to control budget expenditures. I think it does pay for itself in present value, Senator Sarbanes.

It may not pay for itself in the first 10 years. It is a close call on the first 10 years. I also think that the Department is grappling

with a gargantuan task of great complexities trying very, very hard to develop a good, rational process. I commend them for that, and I commend the outreach efforts and the explanatory materials.

I appreciate that the operating framework, for example, is a framework. As someone who regards life as a work in progress, I don't fault HUD for producing a work in progress and issuing it as such. Some places where I do have some concern:

I believe that property-based assistance is better and can be determined to be better in a significant number of cases. For example, once you have lowered rent to market, property-based assistance will in general be cheaper, and you have an opportunity for better accountability. Perhaps not the old HUD with the current regulatory inhibitions, but you have accountability because you know where the property is and you can monitor it. You have cost effectiveness because you have similar people with similar needs.

I also think that property-based assistance gives you an opportunity constructively to create and preserve mixed-income housing. We heard a lot of discussion about the importance and value of mixed-income housing. Vouchers allow-income concentration that you have no observation of and cannot control. There are de facto property-based voucher projects that you don't see and don't regulate.

I concur with Nic that we are concerned about States and localities making these kinds of judgments, because this stuff is not as pizazzy at a State and local level as new kinds of developments. We fear that if it is left to the State and locality there will be a tendency to say, naahhh, do it next year. We won't worry about it until then.

Last, I do not propose that the current HUD be involved in the portfolio segmentation and the restructuring of it. I think HUD is proposing to hire contractors. I support that effort.

I think market discipline has to be brought to bear. But I think that you need to have HUD put out a set of objectives. I share Mr. Haynsworth's concern about the owners. I think the owners are the stewards of the property. If they see a proposal that has the effect of delivering negative consequences to the first few folks who enter into the mark-to-market world, then the folks who come later will have no incentive to invest.

So you have to realize a value on this portfolio over many years. It is important to deal fairly with people at the front end because people are making decisions about the ability of the Federal Government to deal fairly with them, and if they conclude the Government cannot or will not, what you get in mark-to-market will be significantly less attractive than it is today.

Senator MACK. I might ask Mr. Retsinas, if he would, to—frankly, I have read through some of the materials and I find it confusing with respect to reflectors and joint ventures and how it works.

In a few minutes, if you have the ability to walk us through that I'd like to hear it.

Mr. RETSINAS. Sure. Let me——

Senator MACK. In other words, how does it work?

Mr. RETSINAS. Sure. Let me take a crack at that.

As Mr. Smith said, we are continuing to refine these vehicles, but let me give you a summary of the vehicles as it relates to the joint venture.

It is our intent to develop a mechanism where existing owners who are doing a good job—and one measure would be, for example, is a property being kept up—would have an opportunity to work with joint venture partners serving the mortgage insurance-in-force (MIF-JV) so they can negotiate a resolution before the mortgage defaults, and purchase it at——

Senator MACK. Let me stop you again. Who is involved in this joint venture?

Mr. RETSINAS. It would be the current owner——

Senator MACK. Right.

Mr. RETSINAS. It also could be the investors and lender who would benefit from negotiations with the MIF-JV. So that is the preferred option. But again, not for all owners, but to owners again who have kept up the property.

As Mr. Dale indicated, we want to provide disincentives and barriers to owners who have not been good owners over time. So that is the preferred option that we need continually to—as Mr. Smith said—continue to work on.

The reflector sale process is really similar to a process that we now use, the Department now uses, in the so-called 221(g)(4) auctions. It is a process whereby a mortgage is sold before it is taken by the Department. So the Department doesn't touch it, in essence. The mortgage is not assigned to us, but essentially it is sold before that, and using a modified auction process to determine the right amount. So those are the two general processes that we are using.

Senator MACK. Senator Sarbanes, do you want to hop in?

Senator SARBANES. First, Mr. Chairman, let me say I think this was a very helpful panel, although it leaves me sort of even more unsure and less sensitive—I mean more sensitive to the complexities, but I do think that we had obviously people who have worked very hard on their testimony and have done some rigorous thinking.

First of all, the CBO questions that there are going to be any savings. Correct?

Mr. RETSINAS. They question the amount of the savings because we have a different—at this point, we have a different perception of what future claims would be; correct, Senator.

Senator SARBANES. Could you elaborate a bit on why the difference is?

Mr. RETSINAS. I think the two major components of differences—and let me ask my colleague to amplify——

Senator SARBANES. Let me back up a second and let me put this question to you.

Mr. RETSINAS. Sure.

Senator SARBANES. If their estimates were the correct ones, would you want to do this program?

Mr. RETSINAS. I will let my associate Ms. Dunlap answer your question.

Ms. DUNLAP. If their estimates were the correct ones, I think that you would still want to do this proposal because the status quo

presumes that this and future congresses will continue the Section 8 Project-Based forever.

If you are not planning as a Government to continue to sustain that subsidy over time, eventually you would end up marking real estate to market when and if a decision is made to make a different change in the Section 8. Plus, over time our experience with the Section 8 program is that each year the owner's flexibility to effectively manage within the Section 8 program is dramatically impacted by cost cuts, the rent reforms from last year being a classic example of that. Those then stress real estate, which then causes problems in terms of insurance claims.

But to answer the other part of your question, which was what are the specific differences, there are essentially three and Mr. Hale identified them.

The first is that the CBO numbers assume that the current claims, if we maintained the status quo under the older portfolio, are about $200 million over the next 5 years. It is our perception, based upon our experience in enforcing, that that number is very low; that as we begin to address the sick, older real estate that should have been forced to a claim a long time ago, those numbers increase dramatically. So that is one major reason.

The second reason is that their perception of the claims numbers for mark-to-market for the new-assisted or the Section 8 new constructions are simply different than ours by about $2.5 to $3 billion. The reason for that is that their perception is that those properties today are subsidized at rents well above 150 percent of their fair market; and that when that rent comes down, most of that real estate will end up in a claim.

It is our perception that those rents have risen dramatically over market over the years because of the way they are paid; that a lot of money is in the residual receipts accounts; and that those are good properties, I might add. When those owners are faced with becoming market entrepreneurs, they will well be able to do that in more cases than CBO.

The third difference is the one that Mr. Hale pointed out, which is the difference in the shopper's incentive.

Those are the three particular issues. The shopper's incentive is a specific policy issue that the Congress can either choose or not choose.

The others are—the first is one we are experiencing today, which is real claims—and the second is a prediction. The Department has hired Laventhal to assist us in doing an update on the data base that was mentioned earlier. We would expect that to be done by this summer. It is certainly important to us as well as to you that numbers which are currently predictions by a variety of individuals and institutions become something that is based in validated fact.

Senator SARBANES. Which is the "market" to which you are "marking"?

Ms. DUNLAP. The actual market that that particular piece of real estate exists in in its community.

Senator SARBANES. What happens if the object is providing better housing than its surrounding community? In fact, its surrounding community is providing completely inadequate, substandard housing? That sets the market, and it sets the rent.

But if you get housing at that rent in that market, you are getting terrible housing, exactly the housing you have been trying to get people out of.

Ms. DUNLAP. I would suggest that there are two observations.

The first is that if that product is truly providing service delivery and better housing, its market is higher than the property across the street which is ill-maintained, we certainly have situations like that.

The second is that we believe very strongly, as Mr. Retsinas has pointed out——

Senator SARBANES. What do you mean its market is higher? You would mark it to a different market?

Ms. DUNLAP. We don't mark—the proposal, and I think that this is to a great extent built into the comments that I have heard across the table today—we are not talking about the Department selecting a new rent called "market"; we are talking about the owner selecting a new rent called "market."

I think that is very fundamentally different from the business of the past 25 years. That is a sea change—which is, that the Government is not setting and regulating a rent. The owner is determining and maintaining within a marketplace rent as is typical in the marketplace today.

Now if I have a property that is in better condition and offers better services than my neighbor, I should be able to charge a higher rent, unless I am working in a market where folks absolutely have no income choices, and that is why the certificate——

Senator SARBANES. Are you going to eliminate the subsidy in that particular housing?

Ms. DUNLAP. We're not eliminating—we are eliminating the subsidy attached to the property, not the subsidy available to the resident. In 95 percent of the cases, especially the one you just described, the tenants will happily stay where they are because it is better housing.

Senator SARBANES. Does anybody else want to make any observations?

Yes.

Mr. SMITH. I would be concerned about the fact pattern that Ms. Dunlap described. Specifically, you have a good property in a bad neighborhood. What she was saying, in essence, is that you take the subsidy off the property and you attach it to the resident.

If housing is a chair, you make the chair portable and you say to the resident, we will let you buy X amount of chair. Take it where you will.

The problem is that the voucher payment standard is set at a percentile of the median income. It is set at some place vis-a-vis the FMR, the 45th percentile currently, the 40th if HUD's legislative proposal is accepted.

It may be that in the current condition of this property, which is better than its neighbors is, quote, "worth more" than the voucher rent today, but it may be that the only people who would live in that neighborhood are poor people, and the only people who could pay that rent are voucher holders, and they could not pay the rent you needed to keep it in its current condition.

Mr. Haynsworth's project that he was describing down in Florida is in essentially that fact pattern. The voucher rent will not sustain current operations. Of necessity, therefore, one of two things will happen—three things:

The Government will pay more rent because you will decide it is worthwhile, and the Department says let that be done by the State or locality.

The property will deteriorate to the point where you can make ends meet at the regulated rent. I should say as a personal aside I lived in a rent-controlled apartment for 5 years; I do not favor that option.

Or, third, the tenants move and the property disappears.

Those are the choices.

Senator MACK. I would just ask Ms. Dunlap if she wants to respond to those points.

Ms. DUNLAP. First of all, I think that the choices are exactly that. I think I would just simply add that there is a perception here that localities where that particular piece of real estate is wouldn't make the choice to protect their neighborhood and their community, and that is not my experience having been a consultant for almost 20 years for State and local governments.

In fact, it is my experience that they are much better able than the Department and the field offices that I managed to make those determinations today, and to make them in relationship to that particular piece of real estate.

Senator SARBANES. Who is better able to do that?

Ms. DUNLAP. The folks in the community where that real estate is located.

Senator SARBANES. You mean the renters?

Ms. DUNLAP. No. The State or local government that will be operating the Housing Certificate Fund and have the ability under the proposal to make the determination to project-base the support.

Senator MACK. Mr. Dale.

Mr. DALE. I have just a couple of observations.

On the set of cost issues there are a couple of things that were pointed out here that are very, very difficult to quantify, but I just want to make sure that you understand that they will have a strong bearing on the cost of the program to the Government one way or the other.

One is this whole notion of efficiency. There are clearly efficiencies, as Nic said a minute ago. There are clearly efficiencies that will benefit, that will lower costs in a mark-to-market private sector competitive operation.

We all know of instances in the Section 8 program and others where expenditures are higher than they need to be because there is more money there than anybody knows quite what to do with, and those efficiencies will clearly be a benefit that will inure to the benefit of the Government.

On the other side of that, done wrong, so that owners as Mr. Haynsworth indicated are disincented, or know that when they get to mark-to-market they are going to be harmed, there will be a tremendous amount of waste. In other words, an owner I talked to yesterday said, well, maybe I should just start taking every asset I can out of this piece of property if this is what is really going to

happen. So if there is a psychology in the marketplace that causes owners say, I am going to get killed here and I am going to have to pay for the privilege, the result will be additional Government costs.

The third point is, all of the estimates that I have seen have not really had a tax factor in them one way or another, but there could be. There could be a negative tax factor for owners that could be technically positive for the Government. On the other side, if it is not done right there could be a big tax cost to the Government. So there could be a tax effect that would have a budget consequence.

Last, in response to Senator Sarbanes' comment a minute ago about what we are marking-to-market, it seems to me we are marking-to-market the value of the property. We are not marking rents to market that is implicit as one of the calculations. We are not necessarily even marking-to-market today's income stream. We are marking the value of the property to market.

Investors will look at one property in one community and use a cap rate of 13 percent because they don't think it has very much potential for growth and up-side improvement, and for that same property in a different community or location in a different environment that they feel has a real potential for a turnaround and improvement in the operating conditions they might use a cap rate of 7 percent, which would almost double the value of the property. So what we are thinking of when we are marking-to-market, it seems to me, we have to keep clear that what we are marking-to-market is the property's value.

Mr. HAYNSWORTH. Could I just add on that, it is one thing to bid on a portfolio of unsubsidized properties that are mainly garden suburban-type properties, and HUD did have a very successful auction; but it is quite another thing to, as a bidder for example, to look at a subsidized property that has formerly been a Section 8 property and try to guess what the market is really going to be, especially since many of these properties are not in the most desirable locations and there were purposefully put in less-desirable locations.

Senator MACK. I might raise a question, then, along the line of—if I remember correctly, HUD's proposal indicates that these mortgages would no longer be insured by FHA?

Mr. RETSINAS. We are saying certainly from a fiduciary responsibility, to the extent that we can avoid insurance, yes. However, we do have in our proposal the authority to insure. We can understand, as I think Mr. Dale alluded to earlier, there would certainly be situations where insurance would be cost effective going forward.

So we are not saying it would not be. We would like in a sense to complete that deregulation, including not having the insurance, but in our proposal insurance is an option.

Senator MACK. Let me finish with my instincts, and then I want to get to Mr. Dale and maybe Mr. Haynsworth's reaction and whoever else wants, that we have a group of projects that basically were developed and sold on, I would suspect that was able to be accomplished because there was a guarantee on the insurance.

To then now both reduce or eliminate the subsidy and to take projects that may not be in the areas of communities where every-

body is deeply interested in making an investment, and then at the same time say we are going to cut off the insurance, sounds to me like we are creating a situation that does not have much chance to succeed.

I will let you respond, and then you guys can hop in.

Mr. RETSINAS. I think again let's look back before we look forward for a second. In many ways these housing developments are assets. To the extent they are an asset will vary for lots of factors which we have gone into.

The assets were created by the Federal Government. The assets were created by the injection of subsidies, heavy subsidies over time, and the assets in part were created by the availability of credit or insurance overtime.

As we look to the future, to the extent we want to save money—and that is an important factor in this proposal—then one way of saving money of course is just that, the withdrawal of the subsidy and the withdrawal of the insurance.

What I point out to you, what I tried to say, and what I will try to repeat if it wasn't clear, is that as we look forward it is conceivable that there are situations where continued insurance might be an efficient way to proceed.

What I am suggesting is that that decision is independent of the subsidy decision. That ought to be made as a lender on its own merits, and not be artificially sort of propped up by subsidies.

Senator MACK. Then let me ask you a couple of questions, because it seems to me that the decisions with respect to insurance or the guaranty, is critical to making a determination about what the potential write-off is going to be.

Mr. RETSINAS. Oh, clearly.

Senator MACK. So I would be curious as to what percentage of these mortgages you assumed would have insurance, and what percent did not?

Mr. RETSINAS. I think a relatively low percentage would have insurance because, you're right, the valuation of the property and/or the note would be influenced by the availability of the insurance. To the extent clearly was there, that would enhance its value at a cost to the Government—the cost to the Government being a risk of the insurance in the credit subsidy program. So that is the tradeoff. We would envision that the majority would proceed without insurance.

Senator MACK. Now, we will get to all three of you, so be patient.

Mr. DALE. Let me try and outline two examples. We have participated in a number of auctions of real estate that we owned, multifamily real estate. There are several strategies to use in those auctions.

One is to just say, you know, highest bidder, and you find your own financing. Another way is to say "highest bidder, but we will make available to you financing if you want it, and here are the terms."

Either your terms are set with a maximum dollar amount or, more likely, set with a percentage. That is, up to 80 percent, or 70 percent or 90 percent of whatever you bid, we'll be made available to the buyer under the following financing terms and it is your choice as to whether you want to to take that financing or not.

In a circumstance that HUD is facing where you're dealing with a set of uncertainties that are pretty significant—I think Mr. Haynsworth mentioned the idea of taking previously subsidized properties and moving them into a competitive marketplace—that is an uncertainty. The idea of a number of the neighborhoods are not the top-quality neighborhoods, that is an uncertainty. The private sector will discount that. Particularly lender dollars from the private sector will be discounted heavily.

Lenders expect to get paid back what they lend. They have very little up-side participation. It is the equity investor who is hoping to do the turnaround and make 50 percent on their money over 3 or 4 years; the lender just expects to get back the loan with interest.

So they will not be willing to lend into the face of those uncertainties very aggressively at all.

I think that is why the Government would be well served to come up with the right financing scheme—and it doesn't necessarily have to be insurance. It could be financing; it could be a form of financing that was subsequently sold; so there are lots of ways of doing it—but I think if the FHA is willing to participate in financing the solution, that the actual dollars received will be substantially larger.

Yes, there will be some costs or claims later on. There will be some failures. But those failures will be small in comparison with the additional up-front dollars that they are likely to be received.

Senator MACK. Mr. Haynsworth.

Mr. HAYNSWORTH. I think Larry has made some very good points. All I can say is that I think you are going to have, if you do not attach some sort of insurance or creative financing to give some security to the people who are bidding on these mortgages, that you are going to have tremendous discounts and you are not going to realize very much money at all on many of the properties just because of the factors that we've pointed out, much more so than on the southeast auction.

Senator MACK. Again, what has been presented here was that HUD really expects that a relatively small percentage of those mortgages, though, would be insured.

Mr. HAYNSWORTH. Right.

Senator MACK. Do you think that——

Mr. HAYNSWORTH. I just don't think that is the way to maximize the savings that you are trying to achieve, and that is really one of the major objectives here.

Senator MACK. Mr. Smith.

Mr. SMITH. I have a slightly different take. On the one hand, I agree with Mr. Retsinas that in general I would not put FHA insurance on the new loans, not because of the current dollar maximization issue, but because it is the relationship between insurance and subsidy that put you in the trap.

At the same time, I agree with both Mr. Dale and Mr. Haynsworth. Markets like security. Markets like stability. You are going to put properties through operating transitions the likes of which they have literally never seen before. So there are two principles that to me fall out of that.

The first one is: The property ought to have a transition period. To the extent that you want to sell the new note immediately because you want to recover and reduce your cost, then the transition period has to be at an operational level.

We did analysis that suggested that if you put property-based assistance on most of the stock as you were rolling it out, at least for a transition period, you would recover $1.3 billion more dollars than if you did it straight with vouchers, because the markets would say, gee, I can use a lower vacancy rate; I can use a lower advertising and renting budget, and since my stream of cash flows is more certain, I will pay a higher multiplier for that, and the relationship between the market's confidence and the multiplier of recovery is very, very powerful.

So my take on it is: Yes, provide a transition. Provide an outreach to the market to give them that security. I think the more cost-effective and policy effective way is to property-base where you think that gets you bang for your buck.

Senator MACK. Does anybody want to respond to that?

Mr. RETSINAS. I have just one brief comment, Mr. Chairman and pardon the commercial, but to the extent that insurance works and is helpful, whether it is in the minority or majority of cases, it presumes the Department has the authority and the budget to provide insurance, which is of course one of the issues that will come before you, our ability to provide multifamily insurance. So they are in some ways related issues.

Senator MACK. Very good.

Senator Sarbanes.

Senator SARBANES. As I understand it when you showed us the chart, the pie chart where you were isolating things out, you did not—it is only where you had both the insurance and the subsidies that you consider it a problem; correct?

Mr. RETSINAS. Yes, Senator.

Senator SARBANES. Now are there not instances where the State housing authorities have provided in effect insurance, or even put in money and you provide the subsidy?

Mr. RETSINAS. Correct, sir.

Senator SARBANES. What is going to happen in those instances? I mean, I understand the number of Section 8 units are attached to buildings that do not have FHA-insured mortgages, but then many of these projects are financed with bonds issued by State housing finance agencies. So they in effect are going to be put in a box, are they not?

Mr. RETSINAS. I don't think so, Senator. As you recall, my own background came from an agency that in fact financed exactly those kinds of projects. We have consulted extensively with both State and local housing finance agencies and, in the overwhelming majority, they estimate upward of 97 percent of the cases of those Section 8 contracts are coterminous with the financing terms or the bonds. If we go back to our chart, essentially they are unaffected by this because of their coincidence of contract term and bond terms.

Senator SARBANES. Well now are you going to roll back the rents to market levels in those projects?

Mr. RETSINAS. We are going to honor those contracts. We are seeking authority to repeal the Section 142(d) that would allow us to look at Section 8 subsidies and determine whether in fact projects are over-subsidized. But, no, we would not roll back those rents to market rents. The only rents that might be rolled back, if they were over-subsidized, but they would never be rolled back to a point where it would jeopardize the debt service to pay off the bond.

There are some projects, Senator, as you may be aware of, and I'm certainly aware of, where there is, and most people would agree, an over-subsidization. As a result, there have been excessive build-ups of residual accounts, and it is really those that would at least be looked at. But, no, we would not be a wholesale reduction to market rents, sir.

Senator SARBANES. Would you have the—that's because you would handle it in that fashion? Or that because the law would not permit you to do that?

Mr. RETSINAS. It is because——

Senator SARBANES. Is the grant of authority you are seeking broad enough that you could create that problem and you are simply telling me that as a matter of administrative discretion we would never create that problem? Or is the grant of authority you are seeking sufficiently limited that that problem could not be created?

Mr. RETSINAS. The grant of authority is general. I am not only speaking for myself but for future successors to me. It is hard to imagine how someone would do something that would lead to that disruption. Certainly I am open to a restriction on that authority that would make that clearer, because clearly that is not the intent.

Senator SARBANES. Let me ask this question: Is there some way to go at this on a more phased basis, or step by step, or incrementally where we could deal with the clearest aspect of the problem and you could see how it worked and we would not run some of the large risks?

Senator MACK. I wonder if I might add a point to that question? The chart that you several times here indicated that there are two distinct groups of properties. One is the older insured. The other is the newer insured. They have different, no pun intended, properties to them.

Senator SARBANES. You should have intended that pun.

[Laughter.]

Senator MACK. It seems to me that we very well should be thinking about either designing or approaching this problem of looking at those as two different groups and how we should approach those two different groups.

One comes much earlier in the process, and one much later in the process, indicating that in fact there is time to deal with the second group and maybe going through the concept of pilot projects and so forth. So anyway, I hope I didn't confuse——

Senator SARBANES. No. I think that is a very valuable point. Some of our witnesses are telling us, if your calculations are wrong in terms of how people react, you could have big problems. We

could be looking at a far worse situation than the one we are confronting.

Mr. RETSINAS. Certainly there are different properties that have different characteristics. One of the cardinal underpinnings of our proposal is that we honor existing contracts. By that provision we are, by definition, phasing this over time because not all contracts expire next year, or the year after, or the like. They begin to expire we estimate, as I recall—I'll get you the specifics—around 1,200 properties' contracts would expire next year.

So there is a built-in phasing. Again, as it relates to the older assisted projects, we believe the condition of those properties merit attention. Indeed, where on the surface it may look like—and to use somebody's words—a "good deal" for the Government, in fact the condition of those properties requires a reinvestment. If we don't deal with those properties, all we are doing is exacerbating the problem over time.

To answer your question, Mr. Chairman, of course. Anything could be phased, or piloted on any basis that you see fit, but we believe there is a built-in phasing, sir.

Senator MACK. No, I don't think we're looking for that answer, to tell you the truth, we are looking for your sense about what would be the right thing to do.

Mr. RETSINAS. I think the right thing to do would be to proceed down the path of the market. I believe the right thing to do is to have the discipline, we as an Administration and you as a Congress, not just to embark on this but to commit ourselves to constantly review and ask ourselves the question every year: Are we proceeding in the right direction?

Because again we are talking about honoring existing contracts. We are not talking about abrogating contracts. We would like to build incentives for existing owners in advance of contract expiration to participate in the mark-to-market, but that would be on a voluntary basis. But I believe this is a problem that can only get worse as I view the status quo, so I think being about this, this is a phased approach, sir.

Senator SARBANES. The question I guess is whether it can be defined in such a way, whether this requires that it be more limited, that people are better able to make a calculation of what the consequences are going to be.

I am a little concerned here because the testimony has been pretty consistent here that there is a lot of unknown, and you are really setting out on uncharted seas. Some way, you know, if the wind blows this way we will get safely to port; and someone else says, well, I am not sure the wind is going to blow that way. It may blow entirely different. If that happens, you are going to end up way off course somewhere. The question is: Can we get it within a parameter or a framework where we have a better grasp?

People in effect say, well, yes, there are some risks here, but we think that it is certainly on the reasonable side that this might prove out. You have got a lot of parties that are involved here, and you are depending on a lot of reactions out there in the marketplace I guess. You are going to have to make some careful calculations.

Some of the testimony here this morning has been, it seems to me, very instructive in that regard.

Does anyone have any comments on that?

Mr. SMITH. The only thing I would say is that there are constituencies who have a stake in working the housing out. They are, in some kind of order: The residents who live there. The communities in which the properties are located. The people who own them and run them. The Federal Government, which is going to pay the cost one way or the other, and in some large unknown amount. HUD or the new FHA Corporation, or however that evolves, which has the responsibility for administering it. Or if not HUD, HUD's designee at the State or local level.

It does seem to me that, however it is defined, it should be set up so that the interest of all of the constituencies just named is best served by fixing the property and getting the best piece of property on the far end.

Unless you do that, if you have constituencies at war with one another, inevitably the property suffers, and inevitably the taxpayer suffers when that happens—through insurance claims, through subsidy costs, through dislocation, through other kinds of urban problems. If we don't work together, it will cost everybody much more.

Senator MACK. Mr. Retsinas.

Mr. RETSINAS. I agree, which is why Mr. Smith and our other colleagues are here. That is why. This is an important task. As I indicated in my opening remarks, we have engaged in a process of reaching out. We have been having very regular meetings looking at how we can flesh this out in a way that it can be done prudently. So I agree with Mr. Smith 100 percent. Working it out and working it out together are in the best interests of all of us.

Senator SARBANES. Anyone else?

Mr. HAYNSWORTH. I would just like to say on the repeal of Section 142(d), I share a concern about making sure that there is something written into that legislation, assuming it does get enacted, that makes it clear that the property will be protected. In other words, that the mortgage will be protected so that investors won't be hurt in that process.

I know that you have stated publicly here and in some other forums that it is not your intention to ever jeopardize a mortgage. So somehow I would like to see that accommodation made.

Also, the other thing I think, to re-emphasize a point, if you are going to get owners to cooperate—and I think that is the best way to go about working this mark-to-market concept—the basic adverse tax consequences that now occur when there is a reduction of the mortgage simply can't be there because you are going to get a fight on your hands from the owners and investors every time. So there has to be some accommodation of that problem to get owners to cooperate. If that is the case, I think owners would gladly cooperate with—or I would hope so—with the whole concept.

Senator SARBANES. Nic, let me put this question to you: If I am a tenant or someone concerned and trying to find affordable housing, why wouldn't your proposal, to my mind, represent a significant increase in the likelihood that I won't be able to get decent, affordable housing?

The end result of it is for you to take out of the stream of money a significant amount that is going into housing. Now unless you can assert that all of it is the efficiencies that Mr. Dale—that Larry made reference to, why wouldn't the end result be the diminution of housing available to needy tenants?

Mr. RETSINAS. Certainly it would be difficult to overstate that there are some efficiencies by using sort of market discipline and market forces. If you were a tenant, I would say to you, post mark-to-market, you have a choice. You can use your housing certificate which costs you no more; you're still saying whatever your percentage is, whether it is 30 percent, or you raise it to 35 percent, or whatever it is, then you can use that certificate to stay where you are.

Or, if you find yourself trapped, or if that is inappropriate to your own condition or the owning status of the family, you can use that certificate and go some place else. So I would say to you as a tenant, if this is working—and we believe, by the way, that the vast majority of tenants will elect to stay in place, will elect to stay in place, and that will be OK.

In other situations where tenants feel trapped, then they will be able to take the certificate and move some place else. That is what I would say to you is a tenant choice, sir.

Senator SARBANES. Assuming they stay in place, won't their housing deteriorate?

Mr. RETSINAS. No, I don't believe so. As a matter of fact, I think in a number of cases housing may improve. It will improve because mark-to-market will further inject on the owners—not all owners but the minority of owners that are not doing a good job—a market discipline and they will know that they need to keep their property up, because they can't be guaranteed tenancy even if they let their property go downhill.

So I think it will provide an additional incentive to those owners to use the positive value of market forces.

Senator SARBANES. Are the rest of you as sanguine about that?

Mr. SMITH. Nationwide, 82 percent, and maybe slightly higher, of the people who hold certificates and vouchers find housing with it. Is it 87 percent, Nic? It is in the eighties.

Let's turn that around. That means somewhere between 13 and 18 percent of the people who hold a voucher or a certificate don't find housing.

The nationwide vacancy rate in existing affordable portfolio is 5 percent or less. So, aside from the issue of the good property and the bad location such as Warrington Village which we heard about earlier, there is an issue about which markets—Ms. Gaffney said there are markets in which vouchers work. That is absolutely true. It is also true there are markets in which vouchers don't work.

Mr. Dale pointed out a significant number of improvements to make vouchers more market friendly. They should all be done. They should be done to the extent possible.

That notwithstanding, I question whether newly enfranchised and newly empowered voucher holders will in fact find the success rates of utilization that they find in the current stock.

Senator SARBANES. Thank you.

Senator MACK. I thank you.

I really just have one last question to pose, and then we will conclude. It is really directed to Mr. Dale and to Mr. Haynsworth.

As you all heard, I have some concern about the data that HUD can provide us. I don't think there is any dispute about that. We all wish that the data were better. But again in our thinking through kind of how to put together a plan and respond to the initiatives of HUD, this lack of information really is concerning to me.

I guess the way I phrase the question is: If Fannie Mae or anyone else were to engage in a similar type of undertaking, what types of information should it obtain before making a rational decision?

Mr. DALE. One should have comprehensive income and expense data, along with property condition data for all of the real estate in the portfolio.

I think the point of not only having it, but having it in the form that it can be easily displayed, that it can be made available to potential buyers or investors, that people can understand it, is a powerful point.

One of the things we found when we have gone to auction is that the interest in auctioning of properties, ours and others, is much higher if you bring high-quality data to the table.

Now the good news is that when you go to try and encourage third-party investors to invest their hard-earned money in a new venture, if the data is not there, they are either not going to invest at all or they are going to find it themselves. They are going to do a lot of the work themselves to do the analysis. When they do it, that will probably be reflected in the price because they aren't quite as sure of it as they would be if the seller is giving them information that they can rely on. But data is very important both in understanding the inventory and in getting the best execution.

Senator MACK. I was thinking of it, and maybe this does reflect it, but I was thinking of it from the standpoint of if you were putting together a plan for Fannie Mae, what would you want to know in order to make a determination about what you were proposing, whether it is going to either cost you more or save you money?

Mr. DALE. As you probably know, Senator, Fannie Mae is very comprehensive in our analytic work. It would probably take me hours to try and delineate what I would want to know, but let me try and summarize.

Senator MACK. Please be brief.

Mr. DALE. We are doing some analysis now on a complex transaction. What we have tried to do is array some of the key variables. Then, in either a two-dimensional or a three-dimensional format, try and assess probabilities of those different variables occurring in the future and whether interest rates are 4 percent or 10 percent, whether prepayment speeds or owners behavior is this or that.

Whether the cost of the transaction turns out to be $5,000 or $50,000 makes a big difference over a wide variety of assumptions. We try and array many variables, do the best analysis work we can, and then compare the results under different scenarios and pick the result that we think is the most effective, best result for us in the most likely scenarios, or under the widest range of likely scenarios.

We call it a stochastic model, where you essentially run through a series of modeling assumptions, and there are different probabilities of financial circumstances in the future that are applied to your assumptions, and then you end up picking the ones where you got the biggest cluster of best results and highest probability of occurrence.

Senator MACK. You realize the data we're going to be looking at is 1989 data, as I understand it?

Mr. DALE. Yes, I do.

Senator MACK. Mr. Haynsworth, did you want to add something?

Mr. HAYNSWORTH. I don't think any amount of data—it is just so hard to imagine getting accurate data that is really going to guide you effectively.

I guess if you had the time—and I guess we don't have the time, or it is felt that there is no time—that I would take several prototypical types of developments and do a laboratory example, a test, on various types of projects just to see what happens if. But I would make my best guess beforehand. What would be the best way to maximize my return and minimize my losses. But beyond that—because there are so many differences in each of these projects that it would be very difficult to have, to me at least, a one-size-fits-all approach to this.

Senator MACK. OK.

Senator SARBANES. Mr. Chairman, could I ask this end of the table just one question?

Does each of you favor—do you accept the proposition that we should try to move to mark-to-market and the issue is how you are going to do it? If you do it in certain ways you think it will work. If you don't, it won't work? or do you have a basic doubt about moving to mark-to-market? The nonadministration.

Mr. DALE. I think we should be moving toward mark-to-market, particularly on the new Section 8 portfolio. I think it is compelling in the properties in that portfolio. I think the execution will be very important as to whether it is successful or not. We have to pay a lot of attention to the execution.

In that portfolio, as is illustrated, we have some time to move there.

I am less familiar with all of the underlying characteristics of the 236 and 221(d)(3) portfolio. The facts on their surface are less compelling financially, but that doesn't mean that the real estate doesn't need attention. Some of it clearly does. So that one I am less able to respond to your question. But the Section 8 new portfolio, absolutely we need to move in the direction of marking-to-market.

Senator MACK. Mr. Haynsworth.

Mr. HAYNSWORTH. Yes. I agree with that.

I think, because of some of the structural deficiencies in the Section 8 program where you have these huge residual receipts and that sort of thing, that it only makes sense to move in that direction. But I think it really has to be done carefully. I think as David point out previously, all the constituencies really should be consulted and hopefully we can come to some consensus as to the best way to do this.

Mr. SMITH. Yes, you should do it, but you should pick the properties where you save money; where you are bringing above-market rents down. To the extent that you have undercapitalized older assisted properties, you should explore more cost-effective solutions that don't fall within my rubric of mark-to-market but do fall within Mr. Retsinas' definition for the same term. Basically, yes, where it saves you money; no, where it doesn't.

Senator SARBANES. Well, do you have a handy reference point for that?

Mr. SMITH. If current rent is above market, I believe you must inaugurate a transaction at the end of which the property will be paying less debt service. If current rent is below market, you have the opportunity to evaluate whether the physical real estate can sustain itself over time and, if so, whether you want to modify the basis under which you regulate it, or possibly eliminate its regulation entirely.

Senator SARBANES. Thanks.

Senator MACK. Again I want to thank all of you for your participation this morning. You have helped us a great deal, and we thank you for that.

The hearing is adjourned.

[Whereupon, at 12:20 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR ALFONSE M. D'AMATO

Chairman Mack, I would like to commend you for holding this important Subcommittee hearing to discuss the reinvention of the Department of Housing and Urban Development and the redirection of our Nation's housing policy. As you know, HUD is at a crossroads. HUD's fiscal crisis, poor management, and lack of capacity have placed the Department in a situation in which it can no longer continue with business as usual.

I heartily applaud the Chairman for presiding over this essential series of fact-finding hearings which will determine HUD's future. It is imperative that we learn the views of the Administration and housing experts across the country before any HUD reform legislation is finalized.

Today's hearing, the fifth which this Housing Subcommittee has held this year, will focus on HUD's proposal to "mark-to-market" the FHA-insured multifamily housing portfolio that receives HUD Section 8 project-based rental assistance. This is a particularly important issue and I appreciate Senator Mack for thoroughly addressing it in a timely fashion.

The Federal budgetary consequences of extending Section 8 project-based assistance contracts is great, particularly since many of these units are over subsidized. HUD's "mark-to-market" proposal is an attempt to end excessive subsidy payments to projects, by adjusting rents to the marketplace. Given the limited Federal resources and the goal of balancing the Federal budget within 7 years, Congress must find more cost-effective ways to provide subsidized housing. It is clear that the status quo cannot continue.

However, any restructuring of the multifamily portfolio must be made with extreme caution. Adjustments to the rental subsidies may likely cause some projects to go into default, which will cause financial losses to the FHA insurance fund. HUD's "mark-to-market" proposal, which was most recently outlined in a May 26 document called the "operating framework," has not been fully developed.

It is imperative that we fully examine the ramifications of "marking-to-market." I must stress that a reform of this magnitude should not be made hastily. I am extremely concerned about the potential impact of this proposal on the housing community and the financial markets. Further, it is essential that we protect our needy citizens who are residents in the properties that would be affected.

I look forward to the testimony of our witnesses today, and to learning more about "mark-to-market" and any other proposed solutions to this complex and difficult issue.

On a larger scale, the Banking Committee and its Housing Subcommittees will continue to evaluate HUD's recommended "reinvention" and the proposals for its elimination. In the end, we will produce major legislative initiatives to reform HUD. In closing, I urge all involved to remember the fundamental goal of this process, which is to address adequately the affordable housing and community development needs of our citizens in a time of dwindling Federal resources.

PREPARED STATEMENT OF SENATOR RICHARD H. BRYAN

Mr. Chairman, I commend you for holding hearings on HUD's "mark-to-market" proposal to replace project-based Section 8 rental subsidies with housing vouchers, and to also restructure HUD-insured debt to levels supported by market rents.

I think we would all agree there have been many instances of mismanagement of this Section 8 program over many years, and many subsidized rents are way over the market in their housing area. I am concerned this proposal may, however, result in chaos as many very poor tenants are displaced. This proposal seems to assume there are housing choices available in all geographical areas where these tenants are living.

My State of Nevada is currently the fastest growing State in the Nation. As Nevada's population increases, the number of low-income people also increases. The availability of low-income housing has always lagged behind the need in Nevada, and now it lags even further. Many people moving into Las Vegas cannot find affordable housing, as the overall housing needs precipitated by this rapid population growth simply cannot keep up with the demand. The choices for a low-income tenant to use a rental voucher will be limited, perhaps to the point of being practically useless.

Also many of these low-income people are not located in Nevada's most urbanized areas of Las Vegas and Reno. To use a voucher assumes choices exist. But what housing choices are realistically available to tenants living in rural areas of my State, or for that matter in other rural States?

I am also concerned about the "mark-to-market" proposal's costs to the Federal Housing Administration. As I indicated at our May 4th hearing on the future of the FHA mortgage insurance program, FHA can continue to be a major force in housing, but it must remain financially solvent. Under "mark-to-market," I am troubled that FHA could end up paying so many insurance claims to current lenders that its own solvency may very well be at risk.

We need to address the serious problem of subsidized rents which are out of line with the rental market where they are located. I look forward to learning more today about exactly how HUD believes "mark-to-market" can accomplish this without disrupting the lives of many very low-income tenants, and putting the FHA solvency at risk.

PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

Thank you, Mr. Chairman, for calling this important hearing on HUD's "mark-to-market" proposal which would restructure the FHA Insured and Assisted Housing portfolio to reflect the rents of comparable units.

This is a very complex issue and proposal, which impacts some 900,000 units which were generally developed under the old Section 236 and Section 221(d)(3) BMIR programs and the Section 8 new construction and substantial rehabilitation programs of the 1970's and 1980's. Under these programs, many of these HUD assisted units are both FHA insured and subsidized at significantly above comparable market rents. Thus, we face significant costs as these Section 8 contracts come up for renewal over the next 10 years. In addition, most of these housing units house poor families, with almost 50 percent of the housing occupied by the elderly and the disabled.

In order to address the increasing cost of renewing these Section 8 contracts, HUD is suggesting generally that we mark down this housing to market value, remove the FHA multifamily mortgage insurance and replace the Section 8 project-based assistance with Section 8 tenant-based assistance. This is a dramatic proposal and could have dramatic results.

At the outset, I state my support for the premise that HUD needs to restructure its Section 8 project-based portfolio to reduce the costs of the Section 8 program to market value. Moreover, I have had several opportunities earlier this year to review and discuss the HUD "mark-to-market" proposal with HUD and other experts in hearings before the VA/HUD Appropriations Subcommittee. Unfortunately, the "mark-to-market" proposal seems to always be a work in progress in which the questions and complexities grow rather than diminish.

Nevertheless, as appropriations become more constrained as Congress seeks to balance the Federal budget, we have an obligation to find cost-effective ways to provide and maintain affordable housing. This means we need to reduce the cost of Section 8 assistance where practical and cost effective. I emphasize, however, the need to understand clearly the costs, savings, and consequences of the "mark-to-market" proposal.

There are a compendium of "C's" confronting the "mark-to-market" issue—Considerable Cost, Confusion, Complexity, Concern, and Controversy. In Contrast, there is no Clear Consensus on a solution.

Needless to say, this does not bode well for expeditious Congressional action, despite the agreement that reform is needed, and that the over-subsidized multifamily inventory simply cannot be sustained in this budgetary environment, even if we wanted to.

Underpinning the Department's proposals appears to be several fundamental assumptions, among them:

1. Project-based assistance is bad and should be replaced with tenant-based vouchers; and
2. HUD is incapable of directly, or indirectly, managing a multifamily inventory restructuring, so that a rigid, purely market-driven standard should be the sole determinant of how properties are handled. The tremendous diversity of types and forms of housing, the nature of subsidy commitments, and the differing interests that they serve, especially neighborhood stabilization and community development can only be addressed after FHA is out of the picture.

I'd like to challenge all our witnesses today to address these assumptions. As I analyze how the HUD proposal would apply to some segments of the inventory, I am troubled with some of the potential consequences.

For example, we have the case of LIPHRA (preservation) eligible properties which currently charge rents which average only 85 percent of market rent. Even after acknowledging deferred maintenance needs in these projects, "mark-to-market" would require that rents be raised, now lowered, and that Federal rental subsidy costs be increased.

With respect to the assumption against project-based assistance, I find it curious that the Department makes no such complaint about the quality or success of Section 202 elderly and handicapped housing which utilizes 20-year project-based Section 8, or State financed multifamily developments, or Low-Income Housing Tax Credit (LIHTC) projects.

Finally, I am skeptical about the real savings which can be achieved under the HUD "mark-to-market" proposal and I think we need real certainty regarding all costs and savings. I am also concerned about HUD's capacity to implement this proposal, the impact on tenants and the possibility of tenant displacement, the impact on current owners and potential tax consequences, and the impact on projects financed by State housing finance credit agencies and on bondholders. Moreover, I underscore the need to keep solutions simple and straightforward, with an emphasis on fairness and equity to both tenants and owners.

Thank you again, Mr. Chairman. I look forward to hearing and reviewing the testimony of the witnesses.

PREPARED STATEMENT OF SUSAN GAFFNEY

INSPECTOR GENERAL, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

WASHINGTON, DC

JUNE 15, 1995

Mr. Chairman and Members of the Subcommittee, we are pleased to be here this morning as you begin deliberations on HUD's proposal to restructure its portfolio of insured and assisted multifamily housing projects.

Many of these insured and assisted multifamily projects are now facing physical decline or have proven to be far too expensive. Our Office, along with GAO and others, has alerted HUD management and the Congress over the years that the multifamily assisted housing programs were in a state of crisis. We have developed a body of audit work that shows too often tenants and taxpayers have not been well served by these programs. Now, with the impending expiration of rental assistance contracts that support a significant portion of HUD's multifamily insured mortgage portfolio, prompt and sweeping change is essential.

We are convinced that actions are needed to decouple project-based subsidies from insured projects, install market disciplines in these multifamily projects, better serve families in need of housing, and reduce costs. HUD has proposed a very bold plan for meeting these objectives. In testimony before several Congressional committees early this spring, we expressed reservations about the restructuring as originally proposed, particularly in relation to HUD's management capacity. Since that time, the "mark-to-market" proposal has evolved to a realistic framework for moving forward.

We still have concerns about aspects of the proposal. We also have concerns about the ability of the tenant-based Section 8 programs—presented as the alternative to project-based assistance to meet the ever increasing demands for housing assistance in this country in the face of likely reductions in Federal funding. Congress and HUD must find better ways to provide decent and affordable housing for low-income families in need.

In our testimony this morning, we would like to provide our perspectives on characteristics of and problems associated with the project-based subsidy programs, as well as our views on HUD's "mark-to-market" proposal.

Programs Included in "Mark-to-Market" Proposals

As one of the Nation's oldest and largest financial institutions, FHA insures mortgage loans for about 1.6 million multifamily rental units. At the close of fiscal year 1994, the outstanding balance of FHA insurance-in-force for multifamily properties was $45.3 billion. These mortgages represent a major contingent Federal liability. In 1994, HUD established $9.5 billion in loss reserves for the insured multifamily loan portfolio. This represents about 20 percent of the insured multifamily portfolio. Economic downturns in regional markets, changes in tax laws, aging properties, and inadequate HUD oversight are identified as the primary causes for these large estimated losses on insurance claims.

About 75 percent of the FHA-insured projects receive some form of direct subsidy from HUD, in addition to mortgage insurance. These subsidies include interest rate subsidies and/or Section 8 rental assistance. Approximately 9,300 multifamily properties have both mortgage insurance ($28 billion) and Section 8 project-based assistance ($4.8 billion estimate for FY 96 outlays). Between 1996 and 2010, the project-based subsidy contracts on these 9,300 projects will expire. Renewal of these contracts is expected to cost HUD approximately $42 billion in outlays during the next 7 years, and likely over $200 billion during the next 25 years.

The insured portfolio that is assisted through project-based Section 8 can be further subdivided into the older and newer assisted projects.

OLDER ASSISTED PROJECTS

Two basic programs make up the older assisted portfolio: Section 236 projects and Section 221(d)(3) Below Market Interest Rate (BMIR) projects. Both types of projects could receive assistance under the Section 8 Loan Management Set Aside (LMSA) Program.

Enacted in 1961 and continued through 1968, Section 221(d)(3) of the National Housing Act provided for insured mortgages that were eligible to receive financing subsidies through the GNMA. As such, GNMA subsidized loans to developers of low-income housing by purchasing mortgages made by private lenders. Interest rates on those mortgages were administratively set at below market rates, which reduced interest rates on privately written FHA mortgages to 3 percent. The cost of the program was the discount GNMA absorbed when it sold the below market loan at prices low enough to give investors a market yield.

The Section 236 program was enacted in 1968 and was designed to replace the Section 221(d)(3) BMIR program. The program provided subsidies to reduce the mortgage interest to an effective 1 percent rate. This program was the object of considerable criticism, primarily because of a high-default rate and the costly combination of other subsidies. As a result, the program was officially suspended during the housing subsidy moratorium of 1973.

The Section 8 LMSA program, which came into being in 1976, provides assistance for projects with HUD-insured loans that are experiencing immediate or potentially serious financial difficulties. Section 8 LMSA limits tenants' rent payments to 30 percent of their gross income. Rents are adjusted annually based on a project by project analysis performed by HUD of the operating expenses and debt service payments. The primary use of this program has been to prevent the payment of insurance claims by stabilizing the financial condition of projects. LMSA thus began the large scale process of propping up bad mortgages with HUD subsidies. Instead of using market driven techniques to deal with problem loans, FHA made long-term commitments to provide project-based subsidies.

There are about 403,000 units in the older assisted portion of the portfolio which are under consideration for restructuring. These projects are more likely to be distressed because of aging physical plants, with over 50 percent being built before 1960. About 30 percent have a serious backlog of needed repairs affecting both tenant living conditions and project viability. About 95 percent of these projects have rents that are below HUD established Fair Market Rents (FMR's).

The insurance in force for these older assisted projects is about $6.2 billion. Loan loss reserves for anticipated insurance claims have been established for about 32 percent of these properties.

NEWER ASSISTED PROJECTS

Newer assisted projects involve the Section 8 New Construction/Substantial Rehabilitation program that served as HUD'S primary assisted housing production program during the period 1974 through 1983 before being repealed. Assisted families were required to pay up to 30 percent of their income toward rent, with HUD paying the difference between that amount and the actual rent. These projects receive automatic annual adjustments to their approved rent levels based on factors published by HUD. Fewer than 25 percent of these projects have rents below the FMR's.

The newer assisted properties include some 405,000 units mostly insured under Section 221(D)(4) that receive Section 8 New Construction/Substantial Rehabilitation assistance on most or all units. The majority of these projects were built prior to 1960 but because the Section 8 subsidies were established at very high rates, most of them are physically and financially sound. The insurance in force for these projects amounts to about $16 billion.

"Mark-to-Market" Proposal

In late May, the Department released its latest version of the "mark-to-market" proposal in order to solicit input from all interested parties. The proposal calls for

not renewing Section 8 contracts as they expire; transitioning the properties to market discipline by selling mortgages to third parties either at the time of default or through a proactive resolution process; and providing affected tenants with housing certificates to secure housing of their choice. Special protections will be provided for the elderly and disabled residents, along with residents in tight or difficult markets.

PROGRAMMATIC PROBLEMS

The project-based assistance program is essentially flawed in its design and inherently risky. Assisted/insured projects are not subject to the system of market disciplines and incentives that promotes efficient and effective operation of rental housing. The Federal Government assumes almost all financial risk, while project owners benefit from many advantageous situations.

For example, owners are required to have very little equity in the loans; the insured mortgages are non-recourse, meaning that individual owners are not personally liable for the mortgages in the event of default; owners are guaranteed an income stream represented by the monthly subsidy payments; owners enjoy substantial fees associated with management of the projects and identity of interest transactions; and the owners usually realize an assortment of tax benefits. In addition, the incentives to modernize and improve productivity are not market based. Owner incentives are driven by a slow moving, centrally controlled system that does not encourage increased investments to improve cost efficiency.

In effect, the majority of risk involved in these projects is taken by the tenants and the taxpayers. Tenants are seemingly trapped when project conditions deteriorate because their subsidies are tied to the units they occupy and tenants have rarely been able to obtain corrective actions by the owners. Taxpayers are often asked to pay for deteriorated units with excessive subsidies and to fund losses when insurance claims are paid.

PAST STUDIES AND AUDITS

Serious problems with FHA management and practices have been the subject of studies, task forces, and hearings for the last 20 years. As reported over and over by OIG, GAO, and others, HUD's resources for the servicing of the insured multifamily portfolio are seriously deficient. HUD lacks the capacity to manage and monitor its huge portfolio of HUD-insured/held/assisted multifamily properties.

In a comprehensive 1980 report titled "Section 8 Subsidized Housing—Some Observations On Its High Rents, Costs, and Inequities," GAO reported that significant improvements were needed in setting FMR's and contract rents for Section 8 New Construction and Substantial Rehabilitation properties. Based on reviews of such properties in several major cities, GAO found that FMR's and contract rents were too high. Although gross rents were not supposed to exceed the FMR's, except in special situations, GAO found them to be higher in 68 percent of the properties it sampled. GAO also reported that rental determinations were not supported by adequate comparable rents and documentation, and that they contained numerous errors and improper adjustments.

According to a Congressionally mandated study by Abt Associates (issued in September 1993), a total of 4,984 HUD-insured, or held and/or assisted properties, out of a mid-1989 HUD universe of 13,271 such properties, were either distressed or stressed (3,168 properties distressed; 1,816 stressed). According to Abt Associates, the total physical capital needs backlog of the 4,984 properties was over $1.3 billion. Of the 4,984 properties, 3,752 were HUD assisted, i.e., subsidized either through Section 8 or another project-based subsidy program. The total physical capital needs backlog of the 3,752 HUD-assisted properties was $1.1 billion.

In December 1993, HUD's Office of Policy, Development and Research (PD&R) issued a memorandum report on the status of the 4,125 HUD-insured multifamily properties receiving assistance under the Section 8 New Construction and Substantial Rehabilitation programs. PD&R reported that a large proportion of these properties have assisted rents well in excess of the optimal rents they could command in the unassisted market (even after completing physical improvements, amenity upgrades, and repairs). In this regard, PD&R reported that 42 percent of these properties have assisted rents at or exceeding 140 percent of unassisted market rents, while only 23 percent of the properties have assisted rents at or below optimal market rents.

Over the past 15 years, HUD's OIG has also reported similar and other rent-related problems in the Section 8 New Construction, Substantial Rehabilitation and Moderate Rehabilitation programs. The OIG's audit reports document a pattern of excessive Section 8 contract rents and rental subsidies, amounting to hundreds of millions of subsidy dollars, caused by such conditions as inadequate or non-performed rent comparability reviews, incorrect computations of rents, inadequate in-

structions for establishing rents and utility allowances, the non-use of excess project reserves and residual receipts to accommodate project operating cost increases in lieu of granting rent increases, and HUD's failure to maximize potential subsidy savings from reduced debt service costs attributable to tax-exempt bond refundings.

In summary, it is clear that numerous problems exist with the project-based assisted programs. The cost and quality issues demonstrate a need to radically change current housing subsidy policies.

RECENT AUDIT WORK

Our office has just completed a review on the issue of whether HUD should renew existing project-based Section 8 contracts or instead provide rental assistance through tenant-based subsidies. We performed the review in light of HUD's reinvention proposal to convert from project-based assistance to tenant based assistance.

While our report has not yet been issued, our independent review of 46 newer assisted projects in 6 different rental markets (Los Angeles, California; Boston, Massachusetts; Corpus Christi, Texas; Ogden, Utah; Port Orchard, Washington; and Knoxville, Tennessee) disclosed that the average current rent levels were higher than FMR's, comparable unassisted rents, PMA voucher rents, and rents required to support the operating expenses and debt service payments (budget rents) of these projects. When analyzing the projects individually, we noted that:

- 39 projects had rents higher that the FMR's,
- 40 projects had rents higher than Budget rents, and
- 34 projects had Budget rents below FMR's.

This would indicate that a good majority of the newer assisted projects tested could operate effectively within the market without incurring a financial default and voucher holders could still afford to live at the projects.

OIG Views on "Mark-to-Market"

We support HUD's "mark-to-market" proposal for three basic reasons: (1) HUD's ability to manage its large and growing inventory of problem projects is diminishing rapidly and wholesale mortgage resolution offers a viable solution for stemming long term losses; (2) project-based rental subsidies effectively insulate project owners from normal market forces and result in inferior projects and tenant services; and, (3) the assisted housing industry already recognizes the uncertainties associated with continuing long-term commitments of project-based subsidies and the owners have begun, or will begin, disinvesting in these projects. Thus, we believe it is critical that the Congress and HUD move quickly to develop viable plans and to implement the proposals.

Nonetheless, our Office is concerned about several different issues relating to the proposal. First, we are concerned about capacity issues—that is, does HUD have the capacity to do "mark-to-market"? Second, we believe the implementation strategy needs to be as simple as possible; and we therefore question certain aspects of the proposal that introduce unwarranted complexity. Finally, we are concerned about funding problems associated with "mark-to-market" and the overall long term impact on the numbers of eligible low-income families that will be served in the future.

CAPACITY ISSUES

HUD's ability to service its multifamily portfolios has been totally inadequate over the years, as demonstrated in numerous OIG and GAO audit reports and other studies. Thus, there is a natural inclination to question whether HUD has the capacity to implement and carry out the "mark-to-market" proposal in an effective and timely manner. Should it be deemed that HUD cannot handle the job, what are the alternatives?

Our Office has not conducted any in depth analysis of the numbers and types of personnel that would be required to effectively carry out the proposed restructuring, but we do have some views based on past experiences at HUD with other asset sale procedures. For example, several years ago the Government National Mortgage Association (GNMA) was faced with a staggering influx of defaulted issuers and acquired billions of dollars of assets after paying the guarantees.

GNNA established a small cadre of individuals to deal exclusively with disposing of their assets. In a relatively short time period, they successfully moved the assets to the private sector in a very cost effective manner. The crisis now faced by FHA is not significantly different.

FHA staff has recently been involved in several large asset sales involving both single family and multifamily notes. A recent Barron's article had a headline concerning the Southeast Multifamily mortgage sale program it read, "HUD-FHA finally does something right." The successful creation and completion of the mortgage

sales program by Assistant Secretary Retsinas and staff offer some hope that FHA could complete the closely related "mark-to-market" proposals. However, such an effort would require a major commitment of high caliber staff dedicated entirely to this effort. Further, such a staff would have to be empowered to get the job done without political or administrative interference.

IMPLEMENTATION ISSUES

In our view, the sections of the proposal dealing with proactive resolution prior to default, provision of rehabilitation grants, and use of tenant protections (especially for elderly tenants) introduce unwarranted complexity into the "mark-to-market" process. We believe that implementation of the "mark-to-market" process should be kept as simple as possible and largely modeled after the recently successful mortgage sales.

Proactive resolution prior to default has a great deal of appeal because, if successfully completed, such actions could assure a timely transition to market driven forces and potentially save huge amounts of money. However, the concept, to the best of our knowledge, is brand new and will require more exploration before any detailed operating procedures are known. It is our understanding that the Office of Housing is currently asking the assisted housing industry to assist in designing acceptable procedures. Our office is concerned about the high level of vulnerability to loss that is associated with this relatively untried concept.

As discussed earlier, many of the project-based subsidy projects are in need of a great deal of rehabilitation. The "mark-to-market" proposal contains procedures for dealing with the unit quality problems. For the most part, the proposals provide that the private market will assure that needed rehabilitation work is completed. However, the proposals go on to establish exceptions for certain types of properties and allows for possible Government provided capital grants in specific situations. We believe this concept is flawed and has the potential to complicate the process for little apparent gain. We would prefer to simply let the market determine the rehabilitation needs and to reflect such needs in the values they are willing to pay for the mortgages associated with the properties.

In a similar fashion, we are concerned about the various tenant protections contained in Section 6 of the "mark-to-market" proposals. For the most part, the proposals are straightforward, logical, and relatively easy to apply. However, the proposal goes on to provide certain protections to elderly and disabled tenants that significantly complicate the process. The elderly and disabled represent about 50 percent of the tenant population in all assisted housing. Consequently, this policy will have a major impact on the timeliness and cost of the "mark-to-market" process.

Mr. Chairman, we recognize that our concerns and comments on these implementation issues may not be politically correct. Nonetheless, we believe that the process needs to be as simple and straightforward as possible to reduce costs and the vulnerabilities associated with complicated processes.

FUNDING ISSUES

Determining the cost and budget implications of the various "mark-to-market" options has not been easy. Numerous scenarios have been analyzed, costed out and measured against various budget requirements. Nonetheless, we are concerned that the data accumulated to date are not yet complete, accurate and fully reflective of the total costs or savings associated with the restructurings.

A second and perhaps more important concern relates to the Government's overall rental housing assistance policies. It is widely known that current housing assistance programs serve only about one-third of all families eligible for such assistance. Current budgetary constraints indicate that funding will necessarily decrease as attempts are made to balance the budget. Accordingly, we believe that the "mark-to-market" proposal provides an opportunity not only to clean up HUD's balance sheet to reflect true values, but also to stimulate debate about what the new housing assistance policy should be and how that policy fits in the total welfare reform debate.

Mr. Chairman, in closing, I want to assure you that our Office has no higher priority than assisting the Congress and the Department in the effort to reinvent HUD. We will continue working on these issues and providing whatever assistance we can to you and Secretary Cisneros. In the meantime, we have appreciated this opportunity to testify, and would be happy to answer any questions you may have.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Housing Opportunity and Community Development, Committee on Banking, Housing, and Urban Affairs, United States Senate

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MULTIFAMILY HOUSING

HUD's Mark-to-Market Proposal

Statement of Jim Wells, Associate Director,
Housing and Community Development Issues,
Resources, Community, and Economic Development Division

GAO/T-RCED-95-230

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Mr. Chairman and Members of the Subcommittee: We are pleased to be here today to testify before this Subcommittee as it assesses the proposal by the Department of Housing and Urban Development (HUD) to restructure its multifamily housing portfolio, an approach known as "mark-to-market." About 2 million privately owned and managed rental units benefit from mortgage insurance and/or rental subsidies provided by HUD. The proposal seeks to address a variety of problems affecting projects in HUD's multifamily portfolio that both have HUD-insured mortgages and receive rental subsidies tied to units in the projects (project-based assistance) under HUD's Section 8 rental assistance program. The proposal calls for decoupling rental subsidies and mortgage insurance at individual projects and adjusting mortgage debt, as necessary, to help projects compete effectively in the commercial rental market.

Our testimony today is based on work we have carried out during the past several years on HUD's multifamily housing portfolio as well as on our preliminary analysis of HUD's "mark-to-market" proposal. Today we will focus on the following questions: (1) what problems affect the condition of this portfolio; (2) how does HUD believe its "mark-to-market" proposal would address these problems; (3) which properties will be affected by HUD's proposal; (4) what costs and savings may result from the "mark-to-market" approach; and (5) what key issues does the Congress face in considering the proposal?

In summary:

- HUD's multifamily housing portfolio is affected by several serious problems. In many cases HUD pays higher costs to subsidize properties than are needed to provide the households living in them decent affordable housing. In other cases, rents set by HUD are lower than required to maintain the properties' physical condition, contributing to poor living conditions for families with low incomes. These problems stem from, among other things, HUD's dual role as assistance provider and insurer and inadequate management of the multifamily portfolio by HUD, including its limited use of available enforcement tools.
- HUD recognizes these problems and is attempting to address them through its "mark-to-market" proposal. The "mark-to-market" proposal rests upon HUD's belief that the best way to eliminate excess subsidy costs and improve the poor physical condition of some of the properties is to rely primarily on market forces. Consequently, for properties that both have mortgages insured by HUD's Federal Housing Administration (FHA) and receive project-based assistance, HUD generally proposes to replace the project-based assistance with tenant-based assistance, thereby requiring the properties to compete in the market place for tenants. The proposal would also restructure mortgages for properties if such action is needed for them to remain viable without the receipt of project-based assistance.
- HUD's proposal targets about 9,000 properties with 900,000 units that have both FHA mortgage insurance and project-based Section 8 assistance. The majority of these are (1) older assisted properties that receive Section 8 assistance under HUD's loan management set-aside program or (2) newer assisted properties that receive assistance under HUD's Section 8 New Construction or Substantial Rehabilitation programs. A primary difference between the two categories of properties is that the rents in about 67 percent of the older assisted properties are less than the market rents for comparable unassisted units while rents in almost 80 percent of the newer assisted projects exceed comparable market rents.
- It is difficult to forecast the costs and savings associated with HUD's "mark-to-market" proposal. While HUD's proposal should result in substantial reductions in Section 8 subsidy costs, it will also trigger billions of dollars in claims against FHA's insurance fund. HUD deserves credit for attempting to estimate the costs of its "mark-to-market" proposal; however, its current estimates are based on a number of assumptions that may or may not prove accurate and reliable. Accordingly, in our view, these estimates may be subject to considerable error.
- The Congress faces a number of key issues in considering whether HUD's "mark-to-market" proposal represents the best approach for addressing the problems affecting HUD's multifamily portfolio. These include (1) the processes that should be used to restructure multifamily mortgages, (2) the speed with which the "mark-to-market" approach needs to be implemented, (3) the extent to which the Government should finance project rehabilitation, (4) the question of whether loans should be sold with or without FHA insurance, (5) the level of protection and assistance the Government should provide to tenants after project-based subsidies are discontinued, (6) the question of how to improve the usefulness of tenant-based assistance, and (7) the extent to which projects with assisted rents below market rents should be included in the proposal.

Before discussing these topics, we would first like to briefly outline the characteristics of HUD's multifamily portfolio.

HUD's Section 8 Assisted and Insured Multifamily Portfolio

HUD'S Section 8 program provides rent subsidies for low-income families that are linked either to property units (project based) or to individuals (tenant based). According to HUD's data, the Department's Section 8 multifamily portfolio includes about 1.5 million rental units in approximately 19,100 projects that receive project-based subsidies under HUD's Section 8 housing assistance program. Under this program, tenants generally pay 30 percent of their income for rent, and the Federal Government subsidizes the balance. In addition, FHA provides insurance on mortgages for multifamily rental properties. FHA insures $43 billion worth of mortgage loans supporting about 14,700 properties. About $32 billion of this insurance supports loans on multifamily apartment properties. The other $11 billion insures loans supporting about 1,400 projects such as nursing homes, hospitals, student housing, cooperatives, and condominiums.

According to HUD's data, about 9,000 multifamily rental properties are FHA-insured and also receive project-based assistance. About 900,000 units in these properties receive project-based assistance. Beginning in 1996 and continuing for years, large numbers of long-term contracts for Section 8 project-based assistance will expire. Under existing policies, these assistance contracts would generally be renewed when they expire.

I would now like to discuss the key problems affecting HUD's multifamily portfolio.

Problems Affecting the Multifamily Housing Portfolio

As we noted in our March 14, 1995, testimony before this Subcommittee,[1] both HUD and the Congress have a particularly vexing set of problems to deal with in the area of assisted multifamily housing. From the mid-1960's until 1982, FHA operated a dozen different combinations of mortgage insurance, direct loan, and subsidy programs. As HUD itself has acknowledged, many of these programs were flawed in their design and/or operation, resulting in a number of problems including the following.

Many properties receive more project-based Section 8 assistance than what is necessary to provide the households living in them decent affordable housing because HUD is subsidizing rents that are above market rents. In particular, this problem occurs under programs (the Section 8 New Construction and Substantial Rehabilitation programs) in which the Department paid for the initial costs of development by establishing rents above the market and continued to raise the rents regularly. This problem has become more critical as the Congress faces decisions on how to address rising housing subsidy costs in its efforts to reduce the Federal budget deficit. On May 1, 1995, HUD estimated that its costs to renew existing contracts for Section 8 rent subsidies will grow from about $5 billion in fiscal year 1996 to about $14 billion in fiscal year 1998.

In properties covered under other housing programs that operate under different terms, HUD has often held the rents below market rates because it did not want tenants' rental payments to increase. HUD believes that insufficient rental income in these programs has resulted in deterioration in the physical condition of many of the properties.

Other problems stem from the Department's dual role as assistance provider and insurer. This dual role has contributed to inadequate enforcement of HUD's standards for the condition of properties and decisions by HUD to increase subsidies in order to avoid claims stemming from loan defaults.

The design and operational problems affecting HUD's multifamily housing portfolio have been compounded as a result of weaknesses in HUD's ability and efforts to manage this portfolio effectively. As noted in our recent report on default prevention,[2] inadequate management has resulted in very poor living conditions for families with low incomes in a number of insured multifamily properties and contributed to a large number of past and anticipated defaults on FHA-insured loans. Longstanding deficiencies in staffing, data systems, and management controls have impeded HUD's management of its portfolio. For example, HUD does not have the right mix of staff with the proper skills to service multifamily loans and also lacks the data systems it needs to adequately support its loan servicing functions.

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[1] *Housing and Urban Development: Reform and Reinvention Issues* (GAO/T–RCED–95–129, March 14, 1995).

[2] *HUD Management: FHA's Multifamily Loan Loss Reserves and Default Prevention Efforts* (GAO/RCED/AIMD–95–100, June 5, 1995).

In addition, inadequate management of the multifamily portfolio has prevented HUD from consistently identifying and resolving problems that could lead to insurance claims, excessive rental subsidies, and/or substandard living conditions, and the Department's field offices have not adequately followed up with property owners and management agents to ensure that identified problems have been corrected. Furthermore, as discussed in our 1994 testimony, HUD has a wide range of enforcement tools to ensure that owners maintain their properties—such as the option to limit an owner's future participation in HUD's programs—but it has used these tools sparingly and inconsistently.[3]

HUD is undertaking a number of initiatives to strengthen its ability to manage its multifamily housing portfolio. However, many of these initiatives are in the early stages, and it is still too early to determine how effective they will be. In addition, proposed organizational changes and staffing cuts at HUD could, at least in the short run, place additional strains on management of the portfolio and on the implementation of HUD's initiatives to prevent loan defaults. In December 1994, HUD issued its "Reinvention Blueprint" proposing broad departmental changes, including restructuring FHA, in an effort to operate more efficiently and effectively. HUD's fiscal year 1996 budget proposal to begin implementing the Blueprint would streamline HUD's headquarters and field office operations, reducing staff from the current level of 12,000 to about 7,500 over the next 5 years.

Rationale For and Conceptual Framework of Marking-to-Market

Through its "mark-to-market" proposal, HUD intends to restructure segments of its multifamily housing portfolio to address operational and structural flaws. In particular, the proposal is aimed at addressing what HUD believes to be the most critical problem affecting the portfolio—the interdependence of subsidies and insurance claims.

HUD's "mark-to-market" proposal is intended to address these flaws by eliminating or phasing out project-based assistance for the vast majority of assisted properties that are also insured by FHA as the Section 8 contracts on these properties expire. HUD does not propose to abrogate existing Section 8 contracts. Residents living in units that receive project-based assistance would receive tenant-based assistance when the project-based assistance was terminated.

Mortgages on many properties are likely to end in default if project-based assistance is discontinued. Accordingly, the proposal would establish mechanisms for adjusting the projects' mortgages if such action is needed for the properties to be able to compete in the commercial rental market without project-based assistance. According to HUD, this adjustment, which would bring properties' income and expenses into line, would eventually allow the properties to be operated without project-based assistance. As we will discuss later, this adjustment could be done in various ways. However, any approach is likely to result in billions of dollars in costs stemming from claims against FHA's insurance fund.

The effects of "mark-to-market" would vary, depending on whether a property is currently overvalued or undervalued. For a property whose rents exceed market value, "mark-to-market" would lower the property's mortgage debt, thereby allowing the property to operate at the lower market rents. This change should also lead to reductions in subsidy costs. For a property whose rents are below market value, "mark-to-market" would allow the property's rents to increase—potentially providing more money to restore and maintain the property. HUD recognizes that some properties will not be able to provide sufficient income to cover operating expenses even if the mortgage payments for the properties are reduced to zero. In those cases, HUD proposes using alternative resolution methods, including demolition of the property and subsequent sale of the land to a third party, such as a nonprofit organization or local government entity.

As we will discuss later, many of the strategies HUD will use to implement its "mark-to-market" proposal are still being developed.

Properties Affected by Marking-to-Market

HUD's "mark-to-market" proposal targets properties that both receive project-based Section 8 assistance and have mortgages insured by FHA. Over 90 percent of these properties can be categorized as either "older assisted" or "newer assisted."[4] The older assisted properties are insured under either the section 221(d)(3) below

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[3] *Federally Assisted Housing: Condition of Some Properties Receiving Section 8 Project-Based Assistance Is Below Housing Quality Standards* (GAO/T-RCED-94-273, July 26, 1994).

[4] HUD classifies the remaining properties as "other assisted." These include properties that are insured under either the Section 221 market rate, Section 220, or Section 207 programs which also receive Section 8 assistance. Properties that were sold with insurance under HUD's property disposition program are also included.

market interest rate program or the section 236 program that also receive Section 8 loan management set-aside assistance. HUD's data indicate that there are about 4,200 of these properties, with over 400,000 units. The newer assisted properties are insured under any mortgage insurance program that also receives rental assistance under the Section 8 New Construction or Substantial Rehabilitation programs. HUD's data indicate that there are 4,100 of these properties, with about 400,000 units.

Both the older and newer assisted properties primarily serve very low-income households. About 77 percent of the households in the older assisted properties and 90 percent of households in the newer assisted properties have incomes that are less than 50 percent of the local area median. Both the older and newer assisted properties also have a large number of elderly households. About 30 percent of the households in the older properties and 47 percent of those in the newer properties are headed by elderly individuals.[5]

The rents in most of the older assisted properties are believed to be less than the market rent charged for comparable unassisted units, while the rents in most of the newer assisted projects exceed the market rent. HUD's data indicate that about 67 percent of the older properties have assisted rents that are lower than the market rents they could command.[6] On the other hand, almost 80 percent of the newer assisted properties have rents that exceed the market rent. (See app. I.) The same relationship holds when comparing assisted rents to the fair market rents that HUD uses as a basis for computing rent subsidies.[7] About 96 percent of the older assisted properties have rents that are less than the fair market rents while only 4 percent exceed such rents. About 75 percent of the newer assisted properties have rents in excess of the fair market rents.

The financial and physical condition of both the older and newer assisted properties varies. HUD's analysis for the fiscal year 1994 multifamily loan loss reserve evaluated the risk of default for a sample of multifamily projects on the basis of a set of financial, physical, and management data. Properties were then categorized as either excellent, good, standard, substandard, or doubtful. According to the analysis, only 14, percent of the older assisted properties were classified as excellent or good properties whose risk of default and risk of loss in the event of default were considered low. Another 38 percent were ranked as standard properties that do not currently pose a substantial degree of risk but have deficiencies that may pose an increased risk of loss in the future. The remaining 48 percent were either substandard properties whose risk of default and risk of loss were considered medium to high or doubtful properties that presented a high risk of loss. Of the newer assisted properties, 52 percent were considered excellent or good, 28 percent were standard, and the remaining 20 percent were substandard or doubtful.

Costs of Marking-to-Market

During the past few months, HUD has been developing short- and long-term cost estimates for its "mark-to-market" proposal. HUD's estimates compare the cost of its "mark-to-market" proposal with two baseline estimates that represent the status quo option of renewing Section 8 contracts on current terms and conditions as they expire and continuing to provide additional subsidies to reduce insurance claims. The principal differences between the "official" baseline status quo estimate and the "realistic" baseline are that (1) the latter assumes that claims against FHA will increase as the existing stock ages, whereas the official baseline estimate does not, and (2) the increases in subsidy costs are assumed to be higher under the realistic baseline.

HUD's most recent analysis (dated May 30, 1995) estimates that the "mark-to-market" proposal would cost $600 million more than either of the two baseline estimates for fiscal year 1996. For a 5-year period, HUD estimates that "mark-to-market" would cost $3.7 billion more than the official baseline and $2.7 billion more than the realistic baseline. Finally, HUD estimates the 25-year costs of "mark-to-market" computed on a net present value basis would be slightly higher than the official baseline but about $8.6 billion less than the realistic baseline. (See app. II.)

While HUD deserves credit for its efforts in developing these cost estimates, the limitations of the estimates need to be recognized. The estimates are still preliminary and continue to be revised to reflect, for example, policy and implementation

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[5] Information based on study entitled *Assessment of the HUD-Insured Multifamily Housing Stock, Current Status of HUD-Insured (or Held) Multifamily Rental Housing,* Abt Associates, Inc., September 1993.

[6] Information based on HUD memorandum dated January 1995.

[7] HUD annually sets fair market rents for each metropolitan and nonmetropolitan area in each State. These rents represent the cost of modest rental units of a given size and are used to compute Section 8 rent subsidies.

decisions that are still being developed. In addition, and equally as important, some essential information is not available, and "best guess" assumptions must be used. For example, HUD does not have complete data on comparable market rents, the physical and financial condition of the properties currently receiving rental assistance, the structure of project ownership, and other relevant factors that will affect costs. Furthermore, HUD has developed assumptions about relevant unknowns, such as (1) the amount of claims that will result from mortgage restructuring and (2) the number of tenants who will move when portable tenant-based certificates become available—a variable that will affect future subsidy costs. Predicting the reactions of numerous owners, lenders, and tenants to the proposal is difficult at best and subject to significant error.

Mark-to-Market Issues and Observations

In evaluating HUD's "mark-to-market" proposal, the Congress faces a number of significant, and in many cases, highly complex issues. How these issues are resolved will, to a large degree, determine to what extent the "mark-to-market" proposal will correct the problems that now hamper the performance of HUD's multifamily housing portfolio and the amount of any net savings to the Government that will result. The key issues include the following.

HOW MULTIFAMILY MORTGAGES SHOULD BE RESTRUCTURED

HUD's legislative proposal would authorize the Department to use a variety of tools to restructure mortgages, including full and partial payments of claims, sales of mortgages using such procedures as the Secretary of HUD may determine, and agreements with third parties to facilitate mortgage restructuring. Depending on the particular approach or combination of approaches actually used, the effects could be vastly different for the current property owners and tenants, new investors, and the degree to which the process results in long-term net cost increases or savings to the Government.

HOW QUICKLY MARK-TO-MARKET NEEDS TO BE IMPLEMENTED

Appreciable reductions in Section 8 costs will not be realized until projects with New Construction/Substantial Rehabilitation Section 8 contracts are marked to market. Contracts for these projects expire primarily from 1998 through 2004. (See app. III.) Accordingly, some parties, including the National Housing Conference, believe that there is no need for precipitous action on HUD's proposal. However, HUD believes it important to begin implementing the "mark-to-market" approach expeditiously to prevent disinvestment by multifamily project owners in light of the uncertainty about the continuation of project-based assistance. Such disinvestment could result in property deterioration, loss of value, and higher costs.

TO WHAT EXTENT THE GOVERNMENT SHOULD FINANCE PROJECT REHABILITATION

While HUD plans to rely primarily on the private sector to pay for rehabilitation needed to make properties competitive in the marketplace, it believes that relying exclusively on the private sector may not always be the most desirable option, particularly in tight real estate markets. HUD is thus seeking authority to provide advances or grants for rehabilitation when necessary. If this assistance is used to substitute for private investment or to rehabilitate properties that should be demolished, the costs of HUD's "mark-to-market" approach would increase.

WHETHER LOANS SHOULD BE SOLD WITH OR WITHOUT FHA INSURANCE

HUD intends that mortgages resolved through the "mark-to-market" process would no longer carry any FHA insurance, assuming that legislative authorization is granted. As HUD points out, doing so would result in valuing mortgages at the underlying real estate value of the asset. On the other hand, selling loans with FHA insurance adds value to the loans and thus could decrease costs to the FHA insurance fund, at least in the short run. However, it would also expose the fund to the risk of future losses.

WHAT LEVEL OF PROTECTION AND ASSISTANCE SHOULD BE PROVIDED TO TENANTS AFTER PROJECT-BASED SUBSIDIES ARE DISCONTINUED

A variety of concerns have been expressed over HUD's proposal to convert from project-based assistance to tenant-based assistance. For example, while HUD has noted that there is concern that this change will lead to large-scale displacement—as many as 200,000 families—in the first 10 years, HUD believes that these estimates are exaggerated and ignore the fact that elderly and disabled households will be given special protection. According to HUD, while displacements will occur, only about 95,000 households will be affected over a 25-year time period. A clear under-

standing is needed of the extent to which marking-to-market will result in the displacement of tenants and of the actions needed to address this problem.

How to Improve the Usefulness of Tenant-based Assistance

Under the "mark-to-market" process, a key change for tenants would be greater flexibility and choice in deciding where they want to live, stemming from the substitution of portable, tenant-based rent subsidies for subsidies tied to a single property. While holders of HUD's existing tenant-based Section 8 subsidies have for the most part been successful in obtaining housing, this is not always the case. Certain requirements of the current program, such as the "take one, take all" rule, have made some property owners reluctant to participate. At issue is what changes are needed in tenant-based assistance to encourage greater acceptance of the increased number of tenant-based certificates that will result from marking-to-market.

To What Extent Properties With Assisted Rents Below Local Market Rents Should Be Included in Mark to Market

HUD believes that marking-to-market those properties whose rents are currently below market levels can help improve the properties' physical and financial condition, reduce the likelihood that a default will occur, and give the tenants now living in units with project-based assistance the option to move elsewhere. However, including such properties in the "mark-to-market" approach is likely to increase housing assistance costs. For example, HUD's estimate of "mark-to-market" costs indicates that excluding the older assisted properties from this approach would cost $4 billion less over 25 years (on a net present value basis) than including them.

Observations

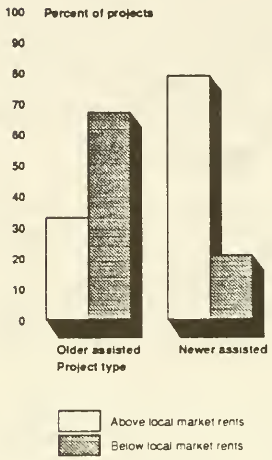
HUD's multifamily portfolio is plagued by a number of serious problems. While HUD has taken and is taking actions administratively to address these problems, it is far from clear how successful these actions will be—particularly given the capacity limitations that currently exist at HUD and are likely to continue into the future. Accordingly, we agree that new approaches are needed to reduce the excessive subsidy costs that HUD currently pays at many properties and to end the payment of subsidies to properties that do not provide safe, decent, and sanitary housing to low-income households.

The "mark-to-market" proposal is a significant departure from HUD's past efforts to deal with the problems affecting its multifamily portfolio. HUD's proposal involves complex issues and has potentially far reaching effects. It is important that these issues be resolved as quickly as possible since delays are likely to lead to project disinvestment, financial uncertainty, and, ultimately, higher costs to the Government.

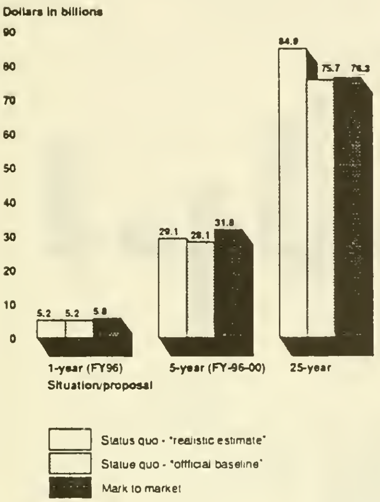
We look forward to working with the Subcommittee as it assesses this important matter.

Mr. Chairman, this concludes our prepared remarks. We will be pleased to respond to any questions that you and other members of the Subcommittee might have.

PERCENT OF FHA-INSURED PROJECTS ABOVE AND BELOW LOCAL MARKET RENTS

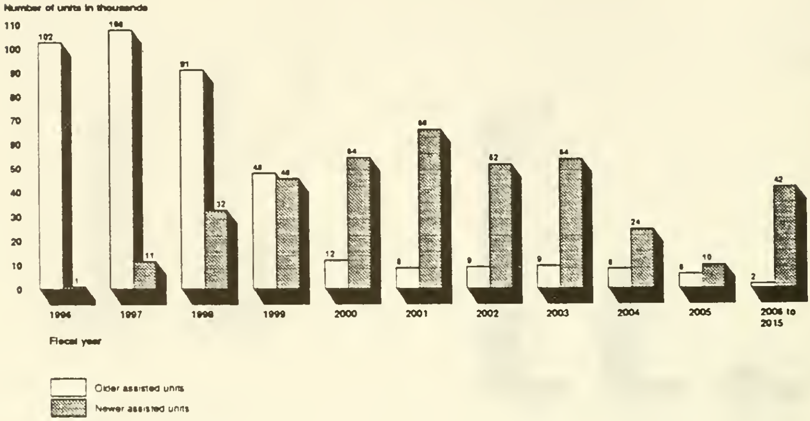


COMPARISON OF HUD'S COST ESTIMATES FOR THE MARK-TO-MARKET PROPOSAL WITH THE COSTS OF MAINTAINING SECTION 8 ASSISTANCE UNDER THE CURRENT PROGRAM STRUCTURE



Note: The 25-year costs are at present value.

UNITS WITH EXPIRING SECTION 8 CONTRACTS IN FHA-INSURED OLDER ASSISTED AND NEWER ASSISTED HOUSING PROJECTS



Note: Figure excludes 39,159 "other subsidized" units whose Section 8 contracts will expire between 1996 and 2008.

STATEMENT BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS SUBCOMMITTEE ON HOUSING OPPORTUNITY AND COMMUNITY DEVELOPMENT

JUNE 15, 1995

By

ASSISTANT SECRETARY FOR HOUSING
FEDERAL HOUSING COMMISSIONER
NICHOLAS P. RETSINAS

Good Morning Chairman Mack and Members of the Subcommittee.

My name is Nicolas P. Retsinas, and I have served as Assistant Secretary for Housing/Federal Housing Commissioner at the U.S. Department of Housing and Urban Development since 1993.

Thank you for giving me an opportunity to testify on our proposal to address chronic structural problems in the federally-assisted "Section 8" multifamily housing portfolio -- a plan better known as "mark-to-market."

First, let me commend you and your Subcommittee and staff for accepting the challenge of addressing the critical problems facing this portfolio. The issues are complex. There are no simple solutions. Reforming the Section 8 project-based delivery system means taking on many entrenched ideas and practices. I appreciate how much courage this requires, and I thank you for your personal involvement.

How we manage this portfolio going forward has critical long-term implications for the federal government -- and for millions of residents in hundreds of communities. The mark-to-market proposal put forward by this Department would directly impact more than 9,000 properties, located in cities, suburbs and rural towns across the country. These properties receive federal project-based assistance under various components of our Section 8 program. The Section 8 assistance is provided pursuant to contracts with private apartment owners.

The mortgages on all of these properties are insured by the Federal Housing Administration. The insurance-in-force on this portfolio totals more than $27 billion. The effect of this overlap of project-based assistance and FHA insurance on the same properties is important to understand. Over the years, the federal government has often averted claims against the insurance fund only by the use of subsidies and a regulatory structure that have masked the true market value of the properties. We have treated the symptoms -- but not addressed the underlying problems.

The vast majority of the residents of the 900,000 apartment units included in mark-to-market are low income, and a substantial percentage are elderly (approximately 40% of the units). The charts

in Appendix A highlight the properties that would be directly included in mark-to-market.

It's Not Only HUD Facing These Challenges

The Section 8 portfolio is not alone in requiring reengineering. In fact, all US real estate underwent profound changes beginning in the mid-1980s. Following the passage of the 1986 Tax Act, the collapse of the savings and loan industry and the enactment of the 1989 Financial Institutions Reform, Recovery, and Enforcement Act, the value of the nation's multifamily portfolio decreased significantly. The thrift industry was the first part of the real estate world to have to deal with declining portfolio values. Soon other private financial institutions -- banks, insurance companies and credit companies among them -- began to mark down the value of their own portfolios and dispose of these assets.

Now the federal government must apply the same discipline to the Section 8 project-based portfolio. We must free these assets from the burden of trying to hold to a value they cannot produce and permit a healthy and sensible recapitalization of the Section 8 portfolios. This must be accomplished in a manner which delivers taxpayers an appropriate social and financial return on their investment and fulfills the fundamental purposes for which these important assets were created. And we must remember that restructuring the portfolio is not primarily about fixing real estate -- but rather about providing for the necessary investment in people and communities.

The Need For Reform

Before describing our mark-to-market plan, let me review briefly why we believe the need for reform is so fundamental. I won't mince words. Section 8 project-based assistance doesn't work well anymore -- notwithstanding all of our best intentions.

One problem is cost. A large wave of assistance contracts expires over the next five years -- beginning with about 125,000 units in FY 1996. (See Appendix B). The long-term economic cost of continuing to provide Section 8 project-based assistance is unsustainable. Maintaining the status quo in project-based assistance over the next 25 years would cost around $200 billion (84.9 billion in net present value). And this does not take into account the billions more that would be needed

over that time frame to rehabilitate these properties to ensure they are decent, safe and sanitary housing. Note Appendix C which illustrates the cost of the status quo versus the mark-to-market approach. The imminent expiration of this large and costly inventory of Section 8 project-based assistance contracts provides Congress the opportunity to undertake reform before the crisis becomes acute and the impact is far more difficult and expensive to resolve.

But cost is only part of the equation. Unless we undertake significant reforms now, we could spend one-fifth of a trillion dollars on project-based subsidies between now and the year 2020 -- and still have a structurally flawed delivery system that is wasteful and limits poor people's choice in the housing market.

These are strong words. But let me explain what we know about the varying components of our Section 8 project-based portfolio.

A substantial portion of our portfolio has been -- and continues to be -- over-subsidized at rent levels ranging as high as 175% of the market for comparable private units in the neighborhood. Appendix D gives a sense of the magnitude of this problem The taxpayers are providing subsidies above market levels to about 3,000 apartment properties. Most of the properties in this category are in our "Newer Assisted" portfolio -- that is, they were financed under Section 8 construction and rehabilitation programs initiated in the mid-1970s.

At the same time, our portfolio analysis also revealed that a significant percentage of our so-called "Older Assisted" properties -- typically built beginning in the 1960s -- are in distressed condition. The reason is not just that these are older properties. Federally imposed rent formulas dictate how much owners can charge tenants to live in these units We provide additional Section 8 operating support -- but typically not enough to support or encourage needed rehabilitation. Tenants living in these substandard units are effectively trapped. Because the assistance is project-based, if they move out, they lose their federal rental assistance.

Much of the cost analysis of mark-to-market has centered around trying to determine which option is more or less expensive over the long-term. But frankly, when it comes to cost accounting, we

should honestly also acknowledge the cost on neighborhoods of having a housing system that is not responsive to market disciplines.

What Is Mark-To-Market?

Our mark-to-market proposal is the result of months of economic analysis and policy debate. It is based on two years of first-hand experience with the portfolio, the project-based delivery system and the budgetary implications. We are aware of the magnitude of what we are proposing and have carefully considered the seriousness of these options.

Under our plan, properties would return to market-based principles, and tenants would have purchasing power and choice in the marketplace. The process, in a nutshell, would work as follows:

- Section 8 project-based assistance contracts would not be renewed when they expire. They would not be terminated early except voluntarily.
- Properties would transition to market. Owners would be free to charge whatever rent the market will bear. HUD will help properties make the transition by facilitating the restructuring of FHA-insured mortgage debt. We will do so by making a partial payment of claim. Our position as mortgage insurer provides a vehicle for us to facilitate the restructuring of a property's debt to a level that can be supported by market rents once Section 8 project-based subsidies expire. We are seeking in legislation the authority to do this efficiently and on scale, using the private sector to the maximum extent appropriate.
- Residents in affected properties will receive tenant-based housing certificates to secure housing of their choice. Special provisions for elderly and disabled residents are addressed in the plan. The proposed Housing Certificate Fund which would oversee this tenant-based assistance is an integral and critical part of the mark-to-market proposal.

The Risk Of Delay

The mark-to-market proposal represents the most significant change in federal housing policy in more than three decades. So it is not surprising that some parties are urging us to delay its implementation. Some have urged us to take more time to sort out all the answers -- from tax

consequences to displacement potential – before transitioning this complex portfolio to a market based system. We have been advised to study the Section 8 project-based portfolio for another year to determine what parts are working and which are not. We have been told that it's wiser to begin with pilot demonstrations before facilitating mark-to-market on a broad scale. Because the conversion to a market basis will not be achieved by abrogating existing Section 8 contracts, there is a belief that mark-to-market can be implemented slowly, in a controlled and orderly fashion.

Such advice may seem superficially rational – and even prudent. Unfortunately, in the real world, we do not have the luxury to delay implementing mark-to-market -- not even for one year. The increased costs to the taxpayers and the further deterioration in the neighborhoods simply cannot be tolerated. It is now critical that all parties involved in the Section 8 debate understand why this fundamental programmatic shift cannot be done piecemeal and why it should not be delayed.

The Financial And Real Estate Markets Have Already Begun To Initiate Mark-to-Market. The markets understand that neither the Administration nor Congress supports funding for Section 8 project-based contracts at their current subsidy levels in perpetuity. HUD has put forward a comprehensive framework to transition away from Section 8 project-based assistance. Some in Congress have also expressed the view that the status quo renewal of Section 8 contracts is not an option. The market is not deaf. Now that uncertainty has crept into this belief system, the markets have started adjusting accordingly.

Indeed, our feedback from the real estate and financial markets strongly indicates that unless Congress commits to continue project-based assistance indefinitely, the private markets will accelerate the mark-to-market they have already initiated. The process will move quickly and spread through the portfolio like a virus [illegible]ers, lenders, property managers and investors have made substantial financial commitments based on the belief that Section 8 would continue. The best way to protect properties, residents and neighborhoods -- as well as owners, investors, lenders -- is to have an orderly mark-to-market plan in place and operational. Otherwise, the assisted housing stock, tenants, neighborhoods and communities are increasingly at risk because:

1. Many owners will disinvest in their properties. They will have no incentive to control costs or take care of deferred maintenance. Everybody will "run for the exits" -- but only after extracting the last economic value from the housing stock.

2. Many lenders will claim "contrived" defaults, and loans will be assigned to HUD.

3. Neighborhood conditions will deteriorate, and some low income tenants will be forced to live in even more deplorable conditions, with no hope of escape.

4. Owners, investors and tenants will initiate a parade of litigation against HUD, seeking to wring money out of the Section 8 program before it expires.

5. HUD will become operationally overwhelmed, and the cost to taxpayers of resolving the Section 8 project-based portfolio will rise. You should know that the U.S. government is not operationally capable of handling the volume of claims that could stream into the Department beginning in the fourth quarter of 1995 as the private sector begins to mark-to-market the Section 8 portfolio.

Mark-to-Market Principles

The Department's mark-to-market initiative is premised on a set of operational principles designed to ensure a smooth transition to market of the Section 8 project-based portfolio. The mark-to-market initiative is designed to:

1. Promote healthy neighborhoods and reinvestment in properties;
2. Provide maximum protection and choice for tenants while minimizing disruption;
3. Rely operationally on the private markets to implement mark-to-market within clear guidelines established by Congress; and
4. Take advantage of HUD's experience in overseeing financial transactions of the type envisioned in mark-to-market -- while recognizing the Department's operational constraints.

1. Mark-to-Market Will Promote Healthier Properties

Mark-to-market's most important contribution will be to restore market incentives and discipline to assisted housing. With the curtailment of real estate tax shelters and the end of inflation driven profits in the 1980s, private multifamily owners were forced to compete on the basis of providing better housing and services to residents at lower cost. And they have done so. Assisted housing lags behind the conventional multifamily industry in this transition because much of its performance is still driven by the need to satisfy government formulas and regulations. One

byproduct is that assisted housing is becoming increasingly expensive to operate and maintain compared to conventional housing. The return is now often based on management fees and services, not return on investments and cash flow.

Among other advantages, the mark-to-market plan will actively encourage the rehabilitation and recapitalization of the assisted housing stock -- particularly our distressed older assisted properties. Such reinvestment will be undertaken primarily with private capital. Rehabilitation grant funds may also be available to assist in this process. Under one approach being considered, we would rely on the private marketplace to take into account the rehabilitation needs of a property when bidding to purchase its mortgage. A second option would delegate to a third party the task of evaluating the need for rehabilitation.

2. Mark-to-Market Will Protect Residents

Once project-based subsidies have ended, rents will transition to market levels -- either up or down -- as set by private owners. Residents who live in units that had been receiving project-based assistance will continue to receive housing assistance -- but this time in the form of tenant-based certificates. The certificates will pay the difference between 30% of the resident's income and the payment standard established by the public housing authority (PHA) for that area.

The PHAs will be required to provide assistance in locating housing for certificate holders who want to move. The proposed Housing Certificate fund adds a further requirement for PHAs in metropolitan areas with concentrated poverty to undertake metropolitan-wide landlord outreach, household search assistance and other activities to increase housing opportunities for certificate holders.

As the shift to tenant-based assistance occurs, current residents will be able to stay in their units -- assuming the owner continues to designate the property as multifamily housing and the resident can afford to pay the new market rent with the certificate. The certificates are portable and may be used anywhere in the country. Certificates can be used to facilitate first-time homeownership.

I would make like to underscore one critical point: The success of mark-to-market depends on Congress appropriating an annual level of tenant-based certificates sufficient to cover all eligible residents in units which lose project-based assistance and transition to market -- and to do so over the full time frame of the transition. Moreover, the workability of the tenant-based program is as important as the availability of the certificates. A flexible and locally administered Housing Certificate Fund is essential.

Displacement Issues. Most of the housing that converts to a market basis under our plan would remain part of the affordable housing stock and continue to be available to residents currently residing in project-based units. There may be some displacement (approximately 65,000 units) when obsolete housing leaves the market (much of which will occur with or without mark-to-market) or in cases where a property's true market rents rise above the level tenants can afford with their certificates. Our analysis reveals that claims of large-scale displacement as a result of mark-to-market are exaggerated.

Elderly Residents. Our initiative addresses the special circumstances faced by elderly residents and those with disabilities. Because of the specialized nature of their housing, these residents could have difficulty locating suitable alternatives if forced to move from their current apartments in the event that the new market rents rose above the levels supported by the housing certificates. Consequently, for elderly and disabled residents currently residing in project-based units, the payment standard that determines the amount of rental assistance they receive will be set at the "reasonable rent" for their current unit, rather than being pegged to the Fair Market Rent for the areas, as are other payment standards. This means that certificates for elderly residents or those with disabilities who choose to remain in their current unit will pay the difference between 30% of their income and whatever market rent is established for their unit, so long as it passes the "rent reasonableness" test for comparable unassisted units.

3. Mark-to-Market Will Rely Primarily on The Private Markets For Implementation

To the maximum extent possible, the work needed to implement mark-to-market will be undertaken by private institutions and state and local agencies, within clear rules and principles established by Congress and HUD. The private markets, not HUD, are best equipped to transition

this housing stock to a sound market basis. Mark-to-market is being designed to capitalize on the growing advantages of privatization.

A timely transition to market will not be achieved by abrogating existing federal financing or assistance contracts. Any resolutions will be based on voluntary agreement to participate or on terminations based on existing contractual rights.

Tax Issues. The mortgage restructurings envisioned in mark-to-market may trigger tax consequences. The Department is not proposing amendments to the tax code. However, HUD will work with the Department of Treasury to analyze the potential tax impact of mark-to-market.

Impact on Bond Markets. Mark-to-market will not affect properties which receive Section 8 project-based subsidies -- but which are not insured by FHA. To date, our review suggests that in the overwhelming majority of cases, the terms of initial tax-exempt bonds backed by Section 8 project-based housing and the Section 8 assistance contracts themselves are coterminous.

4. HUD Has The Capacity To Oversee The Implementation of This Plan

We are confident that HUD can oversee implementation of this plan because it places primary responsibility and reliance for mark-to-market on the private sector and the marketplace. The Department has demonstrated its capacity to manage sophisticated financial transactions of the type envisioned in mark-to-market in our mortgage sales effort. As you may know, in one recent sale, we achieved an exceptional return of almost $710 million on 177 nonperforming mortgages with a face value approaching $1 billion. The net result of that single transaction was to reduce the federal deficit by over $400 million.

Operating Framework. The Department released the Operating Framework for mark-to-market on May 26. We are currently conducting briefings on the operational aspects of the mark-to-market initiative with housing industry groups, resident organizations, state and local government officials, property owners and lenders and the media. Additional research papers are being prepared. As the mark-to-market legislation moves forward, more detailed operational plans and timetables will be developed.

To help properties make the transition to market, we are currently considering two approaches. Both would involve FHA-insured mortgages on properties whose Section 8 contracts will not be renewed upon expiration. One approach would deal with the mortgages after default occurs. The second approach would workout and restructure mortgages proactively, before a default. Both approaches are described in greater detail in the Operating Framework that accompanies this testimony.

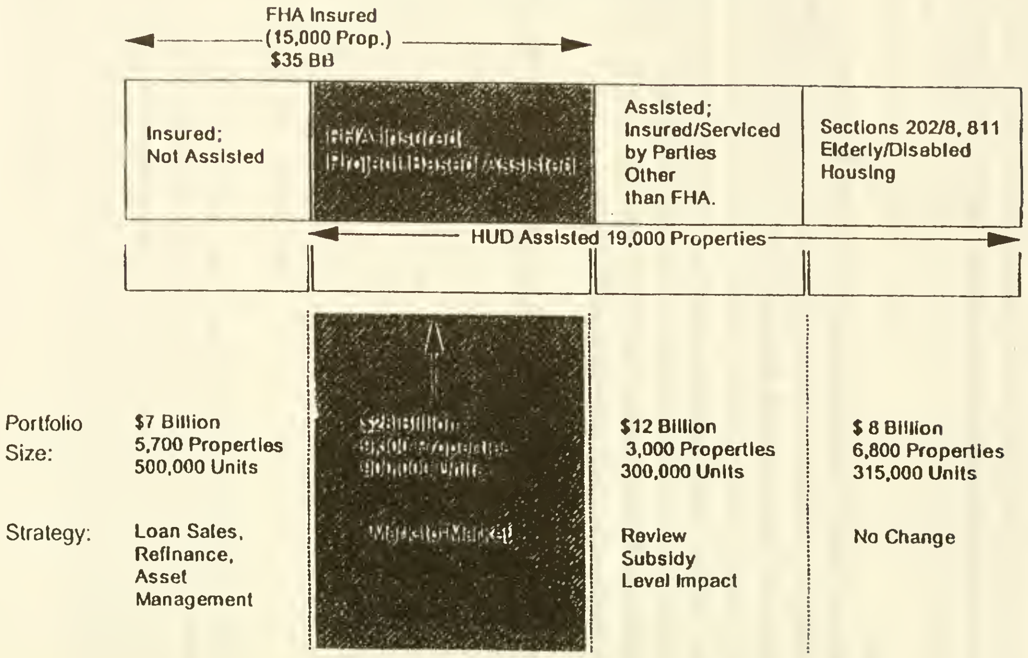
Conclusion

The Greeks have a proverb: "You cannot leap a chasm in two bounds." This Department has put forth a sound proposal which offers a real opportunity to transition the Section 8 portfolio to market in as smooth a fashion as possible. The plan will enable us to promote reinvestment in properties and minimize disruption to residents. Any delay, by contrast, seriously increases the risk of damage to the stock, displacement, deterioration of neighborhoods and waste of taxpayer resources. The Administration has been working with you and your Subcommittee to develop a clear and solid proposal. We believe that implemented expeditiously, mark-to-market will benefit the assisted housing stock, tenants, neighborhoods and the taxpayers.

We look forward to working with you, Chairman Mack, and your Subcommittee to make mark-to-market a reality.

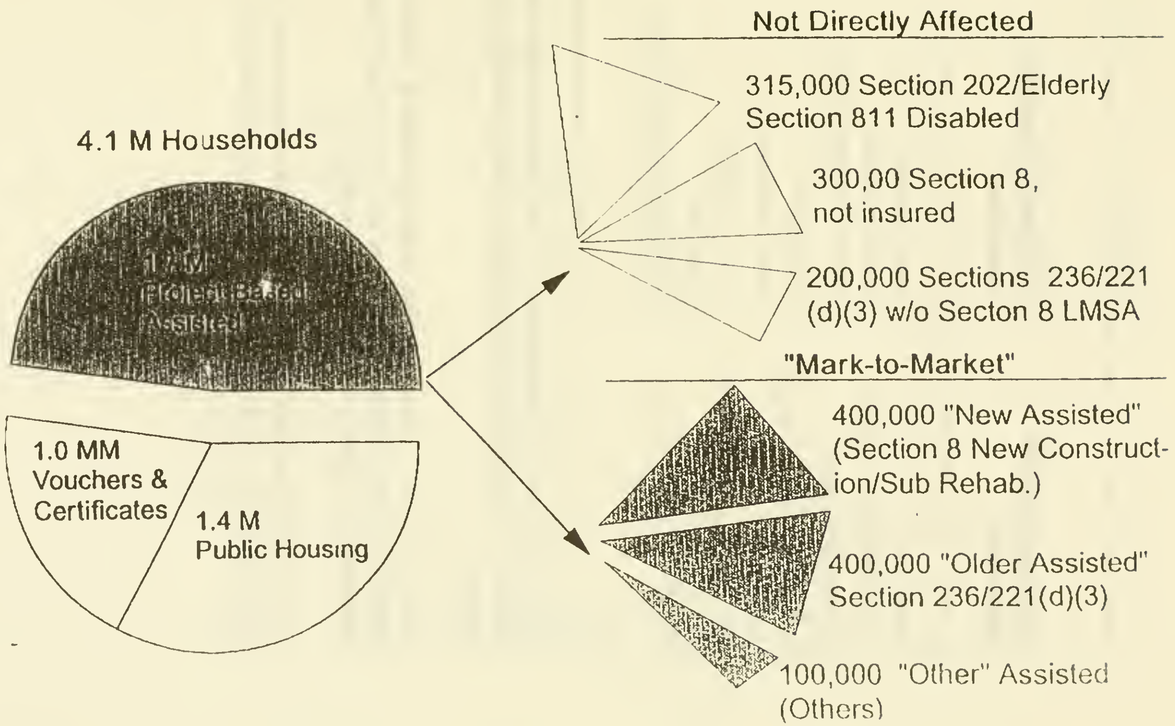
APPENDIX A

"Mark-to-Market" Affects Intersection of FHA-Insured and HUD-Assisted Projects



(Numbers are approximate; for general comparison only)

"Mark-to-Market" Affects only a Segment of Assisted Housing



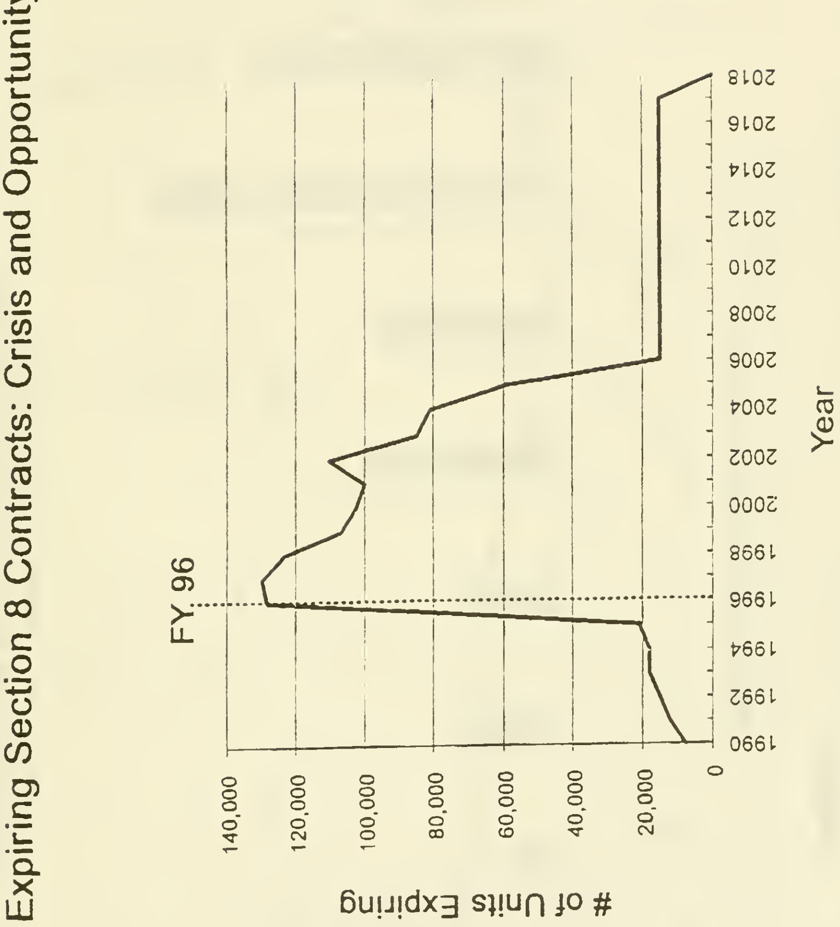
<u>Included in Mark-to-Market Economic Model</u>	<u>NOT Included in Mark-to-Market Economic Model</u>
*Section 236 w/ Loan Management Set Aside (LMSA) *Section 221(d)(3) w/LMSA *Section 8 New Construction/Substantial Rehabilitation *Other FHA insured w/LMSA *Section 8 Property Disposition	*Insured, Not Assisted* *Section 236 w/o LMSA *Section 221(d)(3) BMIR w/o LMSA *Insured, Assisted* *Section 8 Mod Rehab *Not Insured, Assisted* *Section 202/811 *Any Section 8 property not FHA insured

Properties which receive project-based assistance but are <u>NOT</u> FHA-insured are not included directly as part of mark-to-market. However, they will be impacted when assistance contracts are not renewed.

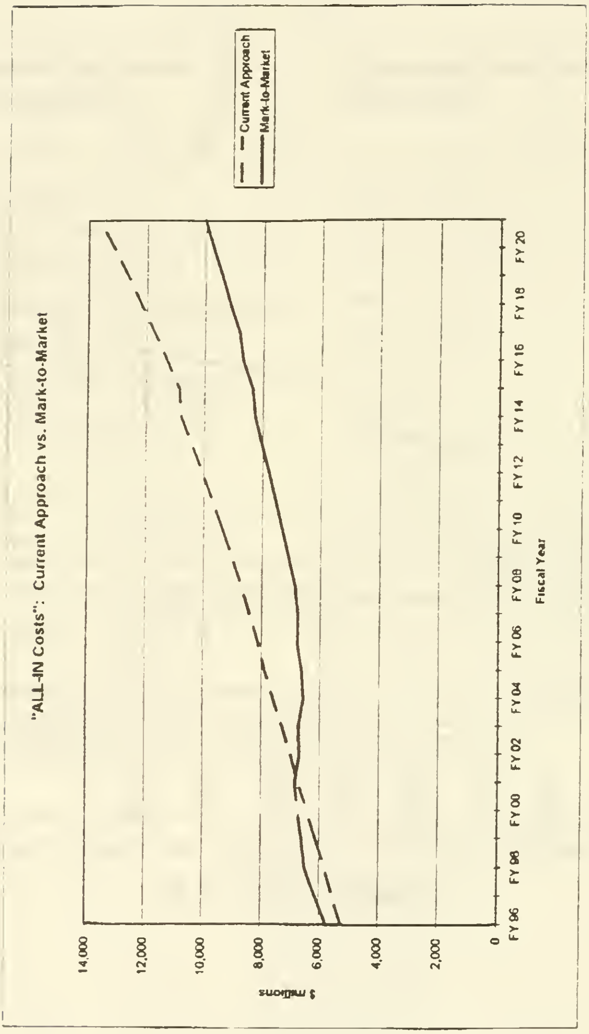
Although they are both FHA-insured and assisted, operational constraints on properties not administered by HUD's Office of Housing have led to the exclusion of the Section 8 Moderate Rehabilitation properties. These may be handled in later phases of restructuring.

No Section 202 properties are included in mark-to-market. This uninsured portfolio is unique, with budgetary ramifications outside of the Department. It will continue to be assisted under the current system.

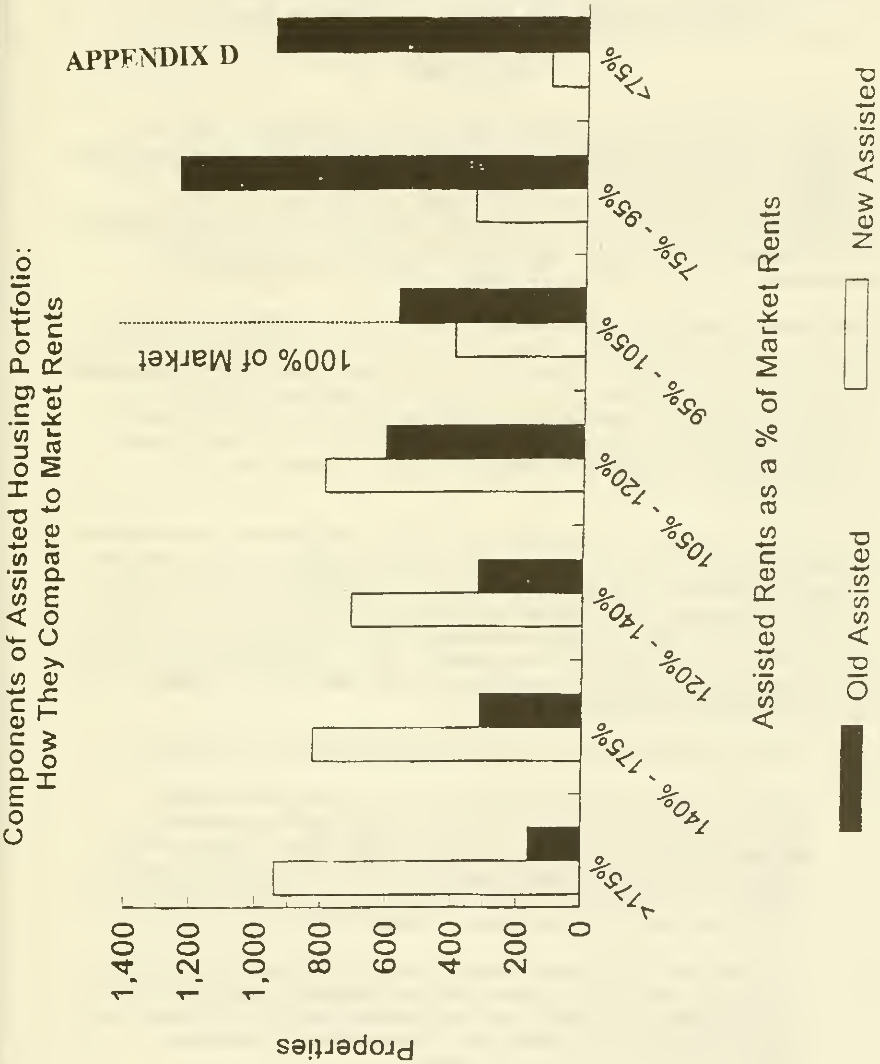
APPENDIX B


Expiring Section 8 Contracts: Crisis and Opportunity
FY 96
# of Units Expiring
140,000
120,000
100,000
80,000
60,000
40,000
20,000
0
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
Year

APPENDIX C


"ALL-IN Costs": Current Approach vs. Mark-to-Market
Current Approach
Mark-to-Market
$ millions
14,000
12,000
10,000
8,000
6,000
4,000
2,000
0
FY 96
FY 98
FY 00
FY 02
FY 04
FY 06
FY 08
FY 10
FY 12
FY 14
FY 16
FY 18
FY 20
Fiscal Year

APPENDIX D


Components of Assisted Housing Portfolio:
How They Compare to Market Rents
Properties
1,400
1,200
1,000
800
600
400
200
0
100% of Market
<75%
75% - 95%
95% - 105%
105% - 120%
120% - 140%
140% - 175%
>175%
Assisted Rents as a % of Market Rents
Old Assisted
New Assisted

Comments on Mark to Market Proposal for FHA Multifamiy Insurance Program

Larry H. Dale

Executive Director, National Housing Impact Division

Fannie Mae

Fannie Mae is the largest investor in multifamily housing among all private financial institutions in America. Fannie Mae's multifamily business serves both standard market-rate housing (which is nevertheless generally affordable to families of modest means) and specifically targeted affordable rental housing markets. We now have some $B of multifamily loans in our portfolio, MBS and credit enhancements. Fannie Mae currently has $3.9B in outstanding FHA-insured loans, representing 3,131 loans. Of these loans, approximately 70 percent have Section 8 subsidies in addition to FHA insurance.

Fannie Mae has relatively little economic interest in the Mark-to-Market issue because we structure our transactions involving Section 8 subsidies to align our contract terms with the terms of the Section 8 contracts. Since HUD's current proposal does not involve abrogating existing contracts, Fannie Mae will not be affected in a material way. We do have a tremendous interest in the impact this proposal may have on the stability of the broader multifamily marketplace, on renters of affordable rental housing, on our many partners involved in the delivery of affordable rental housing, and on investor attitudes about investing in affordable housing.

It appears that consensus is centering around some form of a Mark-to-Market approach and the administration's proposal is a strong step in that policy direction. As we consider the movement toward a Mark-to-Market approach, its success will depend largely on how it is structured and managed. Implementation of the concept could be positive if done well, conversely it could be very painful to residents and costly to investors and operators if done poorly. We believe that particular attention should be given to the following five areas. If these elements can be managed well, it will help to put the Mark-to-Market program on a track toward a positive overall outcome.

1. Vouchers should be structured to work for people, properties and communities.

2. There may be some instances where project-based subsidies remain the best alternative for residents, properties and communities. One example of this is properties designed for physically or mentally disabled persons. Efforts should be undertaken to identify these special instances and allow project-based subsidies to continue. It is important that the Mark-to-Market plan be defined flexibly enough to accommodate needs of particular groups of residents, properties or communities.

3. We support HUD/FHA proposals suggesting the need to create a self-executing mechanism to keep the federal government from individually negotiating every deal. This mechanism must be efficient and fair, and care should be taken to ensure that is does not disadvantage high quality existing owners/operators or advantage inexperienced potential new owners/operators.

4. For decades, affordable rental housing policies and tax polices have been inextricably intertwined vis-a-vis stimulating or attracting investments in affordable housing. We recognize that HUD and this committee do not write tax policy. On the other hand, proceeding with major adjustments to affordable housing policies and not coordinating those adjustments with the tax policies with which they are linked would be unfortunate in that unanticipated tax windfalls or tax losses could result and affordable housing could become more expensive for future generations.

5. Any investor or insurer in income property transactions or programs should maximize the number of tools at its disposal to manage its losses in the most effective way. It makes little sense, therefore, for HUD/FHA to unilaterally remove from its "tool box" work-out options. Better options may include continuing to provide some level of FHA insurance on new loans (and this could be something less than full insurance, such as pool insurance), providing direct financing, or other avenues. HUD/FHA should avail itself of options to work out problem loans other than mortgage sales which rely completely on third party capital.

Testimony

Before the Subcommittee on Housing Opportunity and Community Development
Committee on Banking, Housing and Urban Affairs
United States Senate

Statement of
David A. Smith
President, Recapitalization Advisors, Inc.

Thursday, June 15, 1995

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Recapitalization Advisors, Inc. (Recap) is a Boston-based independent corporation specializing in the finance of existing affordable housing. Aside from representing owners and managers on individual property recapitalizations, the firm also provides objective, quantitative transactional and programmatic analysis on affordable housing finance issues to private owners, trade associations, and HUD on such matters as the FHA Multifamily Loan Loss Reserve, systems for evaluating and compensating property management companies, and the Federal cost and benefit of alternate financing programs.

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Testimony before the Subcommittee on Housing Opportunity and Community Development

MARK-TO-MARKET AND AFFORDABLE PORTFOLIO RECAPITALIZATION IMPENDING CRISIS AND OPPORTUNITY

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EXECUTIVE SUMMARY

Mark-to-market may be the most significant initiative in Federal affordable housing in the last twenty to thirty years. At stake are as many as 900,000 apartments, homes to two million Americans, with an aggregate portfolio value of $20 to $25 billion.

Virtually all expert commentators agree on two crucial points:

- Upon the expiration of existing Section 8 contracts, all above-market rents must be reduced to true market levels.
- Reducing these rents to market will compel restructuring of almost all loans secured by these above-market properties.

At its root, mark-to-market is a *financial* solution to a *financial* problem -- the unacceptably high continuing cost of Section 8. Thus the prime objective against which any mark-to-market scheme must be judged is its *cost-effectiveness over the long term*. At the same time, affordable housing is an expression of Federal social policy, a goal which is directly contrary to maximizing return. The Federal government owes a duty to be compassionate to residents who live in Federally assisted housing, and fair to owners who relied on government programs.

Mark-to-market also enables other *optional* actions, such as:

- Converting from property-based assistance to vouchers
- Deregulating or preserving properties.
- Devolving regulatory responsibility
- Culling bad properties and bad owners

Importantly, although these actions are compatible with mark-to-market, *none of them is intrinsic* – each must be evaluated on its own merits.

Ordinarily a Congress faced with so complex and important a task would take many years to craft careful legislation. That luxury is unavailable – the first contracts will expire this fiscal year. When they do, markets will react. Abdicating legislative responsibility and doing nothing would be the *worst* possible answer – for the residents, for the properties, for HUD, and for the nation. Congress must act affirmatively to fix the problem now or deal with mushrooming losses and massive displacement.

Mark-to-market and related issues may well set the course of affordable housing and urban residential development policy for the next twenty to thirty years.

HUD'S LEGISLATIVE PROPOSAL AND OPERATING FRAMEWORK

In identifying the problem and forcing it into the legislative calendar, the Department of Housing and Urban Development has shown both wisdom and courage. HUD is making a meaningful attempt to grapple with an enormous social and budgetary problem. We wholeheartedly agree with HUD's objectives as enunciated in its recent policy briefings.

HUD has made a genuine attempt to offer possible solutions intended to use market factors and disciplines to minimize net Federal costs, preserve properties, and protect residents. While we recognize the difficulty of HUD's task, we have grave reservations about several crucial components in HUD's proposal:

1. ***HUD's failure to segment the portfolio will increase net Federal losses***. Although HUD offers numerous ways of restructuring mortgages, it proposes two sweeping actions:

    - Conversion of *all* property-based Section 8 to vouchers
    - Complete deregulation of *all* aspects of *all* properties.

    The portfolio is not homogenous. One strategy does *not* fit all. Distinguishing among different types of properties will significantly reduce Federal losses and preserve more housing for more people at lower cost. These distinctions can be clearly drawn and should be a basic element of any recapitalization strategy.

    This papers categorizes the portfolio into twelve subcategories, seven for the older assisted portfolio and five for the newer assisted portfolio, and offers recapitalization approaches for each subcategory.

2. ***Deregulating older assisted properties and vouchering their residents costs money with no corresponding savings***. Many properties (principally in the older assisted portfolio) have rents today below the market yet are in sound or good physical and operational condition. Decoupling subsidy and deregulating these properties gives away the

affordability benefit for which previous Congresses bargained. It costs money and places residents at risk. For these properties, other solutions are much better.

3. ***Immediate vouchering all residents will increase Federal costs and also increase resident displacement.*** As a companion to marking to market, HUD proposes to decouple all subsidy from the properties and make it Section 8 vouchers portable with the residents, then deregulate the properties. While Section 8 vouchers increase resident choice in bad properties, and are the only solution in dreadful properties, they *decrease* resident choice in better properties because they place residents at risk of displacement. Though Section 8 vouchers have a place in affordable housing, they are no panacea and should not be used as if they were.

4. ***HUD's proposed disposition strategies fail to make property owners partners in the mark-to-market effort.*** Mark-to-market will force many mortgages into default; owners fear that this will lead to foreclosure, which would wipe out their investment and trigger large Federal income taxes. If these fears persist, owners will have no incentive to help the process and every incentive to hinder it, and if they do, HUD will recover significantly less money. Conversely, if owners buy in to the process, in both an entrepreneurial and financial sense, HUD will recover more.

Further concerns about the operating framework are presented below.

By circulating its operating framework for comment and scheduling focus-group sessions, HUD s reaching out for input. We support this constructive effort and look forward to working with HUD and the Congress to craft legislation that protects residents, deals fairly with owners, and provides the Federal government with its best practical economic result.

Why Mark-to-Market Now?

Size of the Assisted Portfolio

Today the Federal government regulates or assists about 1,400,000 privately financed affordable housing apartments. As a portfolio, this is good to very good real estate -- but it costs HUD about $10 billion in annual Section 8 outlays just to fund this subset, one of the largest and fast-growing areas of Federal discretionary spending.

In this time of massive budget deficits and overwhelming pressure to cut the Federal budget, Congress has concluded that Sec... 8 subsidy must be cut. Otherwise the Federal government risks skyrocketing Section 8 contract renewal costs for some of its properties.

How We Got Here

Over the last 10-15 years, several slow but inexorable forces -- Annual Adjustment Factor rent increases, the portfolio's inevitable aging, and resident income concentration resulting from continuous application of the Federal rental preferences -- have unintentionally driven many

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HUD-regulated properties away from the market in their rents, operating practices, resident income mixes, and viability.

- *Older budget-based properties* (Section 221(d)(3) and 236), whose rents are generally at or well below market, have been regulated to minimize rents and have seen their market competitiveness slowly atrophy If not reoriented, these properties risk falling into decline because they lack the ability to attract new capital to remain competitive.

- *Newer AAF-driven Section 8 properties* have had their rents rise well above market. Even though most of these properties were *designed* to have above-market rents when originally developed, above-market rents mean subsidy outlays the Federal government can no longer afford.

With each group, however, is a vast stock -- perhaps 325,000 apartments in total -- that are well capitalized and properly balanced between cash flow and affordability. These represent the best of the bargain and should be preserved.

SECTION 8 RENTS AND FHA-INSURED MORTGAGE DEBT SERVICE

Most Section 8 flows to properties whose mortgages are FHA-insured: a subsidy cutback designed to save money will in the short run *cost* money as the mortgages are assigned to HUD Immediate cessation of Section 8 subsidy would also have disastrous consequences for owners, residents, and HUD, because the properties are wholly unprepared for the change. Many are undercapitalized. Many have little contact with market factors and would be badly positioned to compete suddenly. Many properties and many residents have come to depend on their Section 8 subsidy

PUBLIC-POLICY IMPERATIVES

No longer can HUD afford to keep every property. Some properties are too valuable to preserve and should be allowed to escape into the conventional marketplace, with their residents protected via Section 8 vouchers. Others are fatally flawed and cost too much to keep open, these should be removed from the stock, and again the residents should be protected with Section 8 vouchers.

Mark-to-market is an exercise in triage -- selecting for each property the action which is most cost-effective in the long run. This is easy to say and enormously hard to do.

The Federal government must make fundamental changes into its portfolio, simultaneously and as rapidly as possible. HUD must cut costs, but must act wisely This suggests eight public-policy imperatives:

1. *CUT ONGOING SECTION 8 SUBSIDY COSTS*

Without conscious action by Congress, Section 8 outlays have become almost a *de facto* entitlement, since no Congress before now has been prepared to accept the mandatory outlays associated with dropping rents and putting the mortgages into default. This Congress is prepared to break the cycle in pursuit of a balanced budget.

Thus, *any mark-to-market strategy must be judged first and foremost by whether it cuts ongoing Section 8 subsidy costs, and if so by how much.* Maximizing savings is a categorical imperative.

2. *REDUCE SUBSIDY DEPENDENCY*

Properties dependent on Section 8 for their operating viability are eternally vulnerable to future default. They must be recapitalized so that their continued viability rests with market rather than subsidy forces This must be reversed at both property and individual levels, including:

- Changing Federal preference rules to allow more mixed-income tenancy able to pay a higher tenant share of rent.
- Strengthening properties' operating budgets (by increasing their working capital, increasing replacement reserve deposits and capital reinvestment, and allowing greater cash flow) so they have more operating margin.
- Writing down first mortgages to reduce their required debt service and allow properties to break even or generate cash flow with true market rents.

3. *RESTORE MARKET COMPETITIVENESS*

Rents away from market insulate properties from market discipline, which in turn allows them to become lethargic. To keep the portfolio cost-effective, and to assure that the Federal government is receiving maximum benefit for its resources expended, properties need to be made market-competitive, through::

- Allowing below-market properties to raise their rents closer to market. This does *not* necessarily imply complete deregulation, however, which would give away the benefits of favorable bargains the Federal government made twenty years ago.
- Reinvesting cash generated from improved operations back into the property as new market-competitive amenities
- Creating economic incentives to own properties and management them well

- Reducing HUD's distorting influence on management by eliminating process-oriented regulation and substituting results-oriented accountability.

- Attracting new non-Federal capital to reinvest in these properties.

- Restoring choice to residents who today economically trapped in bad properties. (Section 8 vouchers are a component in this strategy but not a panacea. Property-based assistance will be warranted in many circumstances.)

- Using market risks and rewards to enforce owner and manager accountability in delivering a good property at competitive rents.

To prevent displacement, disruption, and a cascading effect of lost value, *these changes must be done on an accelerated but not abrupt basis* Reaching this situation took fifteen to twenty-five years; reversing it will take five to ten years.

4. *Minimize Displacement*

By itself, mark-to-market will cause no displacement, but attendant consequences can cause significant displacement.

- Allowing older assisted properties to prepay risks displacing 100,000 families (or alternatively, providing Section 8 vouchers to most of them, at costs higher than that required to preserve the property).

- Deregulating rents at newer assisted properties risks displacing 53,000 families.

- Failing to support good properties in marginal locations whose market rents are too low even to support current operating expenses risks displacing 75,000 families.

For each of these problems, solutions can be devised compatible with mark-to-market. Doing so adds complexity and raises the net costs of marking to market.

Nevertheless, the residents are the beneficiaries for whom this housing was created Their welfare should be as important as the financial imperatives.

5. *Deal Fairly with Owners and Investors*

Mark-to-market will put owners and investors in peril, because it will throw their properties into financial default and make it impossible for them to continue paying current debt service. If the owners are foreclosed, they will lose ownership and management, plus face large Federal income taxes resulting from cancellation of indebtedness

Such a result serves no public purpose and is grossly unfair to people who invested in good faith and who have performed ably over twenty or more years. Owners and managers

should not be insulated from the consequences of their actions, nor should they have bestowed upon them newly created equity carved out of the Federal government's recovery. At the same time, owner reinvestment will make the properties better, and their support for mark-to-market will increase net Federal recoveries from the recapitalized properties.

Mark-to-market should be handled so that capable owners and managers survive without adverse financial or tax consequences.

Dealing fairly with owners and investors is crucial to the success of the next imperative as well.

6. *Preserve Access to the Capital Marketplace*

In marking to market, Congress and HUD are going to the private marketplace -- of owners, managers, and investors (both debt and equity) -- and asking them to reinvest in this affordable housing stock. By their nature, economic markets are essentially ruthless and extraordinarily reactive -- they pursue profit single-mindedly and change course rapidly. Thus, to encourage marketplace reinvestment, Congress and HUD must demonstrate that they are going to be good partners.

The stakes are highest for the *first* properties, because the markets will regard them as bellwethers.

If the markets -- or the owners -- conclude that HUD will be a bad partner, they will disinvest. Owners will prepay or opt out, capital sources will increase their premiums or withdraw entirely. All of these actions will cost HUD money.

7. *Recapitalize the Affordable Housing Stock*

To continue to serve as quality affordable housing, many older assisted properties need reinvestment and recapitalization.

Contrary to some assertions, the older assisted portfolio is *not* in danger of imminent physical collapse, nor is it suffering from pervasive or critical deferred maintenance. Rather, the explanation is simple. For the last fifteen years HUD has generally ranked resident rent abatement as more important than capital reinvestment. Managers who sought to build up replacement reserves, or more aggressively to replace older appliances, have had to fight their HUD field offices to do so. More commonly, the managers have deferred to HUD's wishes and let physical systems continue to the end of and beyond their theoretical useful life.

Visitors today find properties that are perfectly serviceable but look a little tired, with ten-year-old refrigerators, out-of-date carpeting, cabinets that need refacing, and spartan bathroom fixtures. This overall dowdiness is neither irreversible nor a significant impediment to subsidized operations, but will prove a real handicap in the competitive rental marketplace.

Without faulting HUD for its policy, the time has come to reverse direction and emphasize long-term capital reinvestment over short-term rent abatement. Replacement reserve fundings should be increased. Capital reinvestment should become a line item in the operating budget. Managers of properties with rents below market should be encouraged to rebuild them *using their current rent stream*.

8. *CULL BAD OWNERS AND BAD PROPERTIES*

Although serious problems are rare, they are visible and persistent. In recent years, the portfolio has come to be defined solely by its problems rather than by its successes; these few eyesores have ruined the reputation of an entire industry. Continued inability to remove bad owners or to fix seriously troubled properties undercuts all initiatives in affordable housing.

Because mark-to-market opens a new negotiation on every property involved, it represents the perfect opportunity to clean up the portfolio by culling bad owners and bad properties.

WHAT PROPERTIES ARE INVOLVED?

Over the last twenty years, HUD has sponsored about a dozen different mortgage programs, as well as a half-dozen subsidy programs. These do not categorize neatly into a taxonomy -- exceptions abound and generalizations are usually false. That said, we believe Congress can usefully subdivide the potential universe of properties suitable for marking to market into two large groups:

- The older assisted portfolio (about 640,000 apartments, about 65% Section 8).
- The newer assisted portfolio (about 450,000 apartments, 99% Section 8)

As a whole, this portfolio is large. It comprises:

- About 900,000 apartments' worth of Section 8
- About 2,500,000 Americans living in these apartments.
- Annual Federal outlays of about $6.5 billion.
- About $20-25 billion in property value
- Potential mortgage defaults of $12 billion, with perhaps $4 billion in recoveries, for net claims of about $8.2 billion[1].

Within these two groups, ,ill also draw further distinctions based on operational similarities affecting the choice of Congress's best action.

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[1]Estimates of the universe are taken from *Section 8 Mark to Market: Net Costs and Benefits Under Different Assum: is*, prepared by Recap Advisors in April, 1995. Subsequent estimates by the Congressional Budget Office (CBO) have resulted in a remarkably similar estimated net capital cost of marking to market.

OLDER ASSISTED PROPERTIES

About 640,000 apartments sharing the following common features.

- Developed between roughly 1968 and 1976.
- Original rents were held *below* market through use of below-market debt service.
- HUD programs 221(d)(3) Below Market Interest Rate (BMIR), Section 221(d)(3) Rent Supplement, and Section 236.
- Rents set annually using a budget-based approach with limits on annual cash dividend distribution.
- About 15% were all-elderly properties; of the remaining 85%, about one-quarter of the residents today are elderly, for an overall elderly population of about 25% of the apartments.
- Section 8 Loan Management Set Aside (LMSA) was added to the properties when needed to avoid mortgage default. Today about 65% of this portfolio, or 430,000 apartments, have Section 8 LMSA.
- About 25% of these properties have rents today above local market levels.

NEWER ASSISTED PROPERTIES

About 450,000 apartments sharing the following common features[2]:

- Developed between roughly 1977 and 1983.
- Original rents were typically *above* market and were supported with property-based Section 8 for all apartments.
- HUD program 221(d)(4) and close relatives (Sections 220 and 231).
- Section 8 rents using the Annual Adjustment Factor (AAF) for all apartments.
- Section 8 contracts *shorter* than their mortgage term.
- About 45% were all-elderly properties; of the remaining 55%, about one-quarter of the residents today are elderly, for an overall elderly population of about 55% of the apartments.
- About 90% of these properties today have rents above local market.

As a group, these properties tend to be in better locations than the older assisted portfolio, with significantly greater representation in suburban communities.

A tabular comparison of the older and newer assisted portfolios is presented as Exhibit 1. The same presentation is shown in a schematic chart in Exhibit 2.

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[2]In compiling the newer assisted portfolio, we have omitted the 315,000 Section 8 AAF apartments financed by state housing finance agencies (HFA's). Of these, about 235,000 have long-term contracts and would in any case be exempt from mark-to-market; for the remaining 82,000, we are recommending that they be subjected to a less stringent form of mark-to-market, as outlined later in this paper.

WHY ARE CURRENT RENTS ABOVE MARKET?

As mentioned above, rents are above market generally *because they were designed to be*

- Property locations were selected for development precisely because their local markets could not support quality housing ad the Federal government was seeking to stimulate urban revitalization.
- Federal regulatory requirements (amenities, construction fees, construction costs, Davis-Bacon wage rates) inflated original development costs above levels supportable in the local markets.

Sc⁻ᵉ properties have rents above market simply because of contractual commitments

PORTFOLIO SEGMENTATION IS ESSENTIAL

These properties are not homogenous. Portfolio segmentation is essential, not simply between th. older assisted and newer assisted portfolios, but *within* each group. The portfolio can be categorized into twelve groups, seven in the older assisted and five in the newer assisted. We offer educated guesses as to how many properties are in each group.

OLDER ASSISTED PORTFOLIO

Within the older assisted portfolio are seven categories of properties, stratified principally by their current rent relative to true market. Briefly, the seven categories and their best resolution strategies are:

Category 1: Above Federal Cost Limit (20,000 apartments, 3% of older assisted). These properties are so valuable that preserving them would cost significantly more than providing vouchers.

Category 2: Prese. vation Viable (75,000 apartments, 12% of older assisted). These properties would prepay and convert to conventional use if they could, but HUD can preserve them (via a capital grant/loan or similar mechanism) more cheaply than vouchering the residents.

Category 3: Rent Suppressed (125,000 apartments, 19% of older assisted). These properties could raise their rents, but not enough to make preservation viable. They should keep property-based a[illegible]nce, perhaps with incentives to wean them away from Section 8 LMSA, at slightly higher rents to allow reinvestment.

Category 4: Equilibrium (150,000 apartments, 23% of older assisted). These properties are serving their marketplace today at or near true market rents. Little action is necessary or desirable, except perhaps some reinvestment in improving the property.

Category 5: Subsidy Dependent (170,000 apartments, 28% of older assisted). These properties are sustaining rents above market solely through use of Section 8 LMSA. These need to be marked to market

Category 6: Troubled (70,000 apartments, 11% of older assisted). Even with Section 8, these properties are struggling. They need mark-to-market plus a workout, and if workout is impossible, foreclosure.

Category 7: Fatally Flawed (30,000 apartments, 4% of older assisted). These properties will never be cost-effective. They should be removed from the stock and their residents vouchered.

A graphic depiction of these seven groups is presented in Exhibit 3.

About 57% of the older assisted portfolio has no need to write down its debt. For these 350,000 apartments, continued property-based assistance and regulation is clearly cheaper than deregulation and vouchering. (*Improving* regulation is desirable, as is devolution of regulatory responsibility, but these are peripheral considerations not central to mark to market.)

NEWER ASSISTED PORTFOLIO

The taxonomy of the newer assisted portfolio is similar to but simpler than the older assisted portfolio; it has only five categories.

Category 1: At or Below Market (50,000 apartments, 11% of newer assisted). Like their counterparts in the older assisted portfolio, these properties could sustain or increase their rents if deregulated. No action is necessary or desirable.

Category 2: Mark-to-Market (280,000 apartments, 66% of newer assisted) Properties in this group (by far the largest in the newer assisted portfolio) have above-market rents and will require debt restructuring after rents are reduced. For this core group, mark-to-market is essential

Category 3: Zero Cash Flow (50,000 apartments, 11% of newer assisted) These are good properties that could not even pay their operating costs if rents were reduced to true markets. Usually they are in marginal inner-city neighborhoods, or small rural communities In either case they are usually the best housing in their community and serve as a community anchor. They should be supported with additional resources, because closing them would be foolish.

Category 4: Troubled (25,000 apartments, 6% of newer assisted). These properties are essentially similar to their counterparts in the older portfolio. Mark-to-market is a necessary step, followed by workout or foreclosure.

Category 5: Fatally Flawed (25,000 apartments, 6% of newer assisted). These properties should be quickly removed from the stock and their residents protected with Section 8 vouchers.

A graphic depiction of the newer assisted portfolio, using the same format and to the same scale as the older assisted portfolio, is presented as Exhibit 4.

Significantly, expected mortgage recoveries from marked-to-market newer assisted properties are much higher than for older assisted -- we have previously estimated that as much as 40% of original face amount, or $3.5 billion, could be recovered. A well-designed asset recovery strategy will be well worthwhile.

IMPLICATIONS OF THIS PORTFOLIO CATEGORIZATION

1. ***The role of Section 8 LMSA***. Within the older assisted portfolio, three categories (preservation viable, rent-suppressed, and equilibrium) have properties whose current rents are below market levels. A large fraction of the residents in these properties are low income families receiving *no* Section 8, yet paying the current budget-based rents. In these properties the Section 8 LMSA, which was originally provided to prevent defaults, is no longer serving as a default protection. Instead it is easing the rent burden for residents, typically very low income, who cannot afford even a below-market rent[3].

For these properties, marking to market will neither reduce costs nor shrink the ongoing Section 8 outlay commitment -- it will increase both. To cut Section 8 costs will require scaling back resident benefits, which is feasible (at least in a real estate sense) without jeopardizing the property.

2. ***The elderly are a principal resident group***. Elderly residents comprise the largest single group of beneficiaries of affordable housing. Not only is about 30% of the portfolio specifically reserved for them (45% of the newer assisted and 15% of the older assisted), elderly residents have moved in to about 25% of the remaining family apartments.

In general, the elderly value security and community more than mobility. They thus generally enjoy living in affordable housing properties. Properties that have large elderly populations also serve as a convenient nexus to bring in other services the elderly need, such as wellness programs, hot meals, transportation, and social activities. The properties in question, originally developed as mere apartment complexes, have become *de facto* senior citizen social service centers, with their managers providing an array of services and programs far beyond rent collection and bill paying.

Elderly occupancy of assisted housing is among the portfolio's greatest success stories -- and its least heralded.

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[3]As a general matter, families with income greater than 60% of area median can usually afford the budget-based rents in these older assisted properties

3. ***True market rent is hard to determine because it is so localized*** Our analysis has used as a proxy for market rent the Section 8 Fair Market Rents (FMR's) published by HUD every year for every Metropolitan Statistical Area (MSA) in the country MSA's are by definition broad regions, within which lie many different neighborhoods and markets. Establishing a true market rent for a particular property is no trivial matter.

Vouchers cut through this difficulty by establishing a flat payment amount (currently the 45th percentile, proposed to be lowered to the 40th) and letting residents seek housing in the marketplace. This amounts to *de facto* exclusionary zoning because residents are limited to the bottom portion of the available rental stock.

Many of their current properties are in the top half of the rental stock -- a lot can happen to a city in twenty years. Residents in these properties are enjoying a stable tenancy in an attractive community. While the Federal government may choose not to continue to provide this housing, it must recognize that cutting back to an FMR-based voucher standard would have the effect of economically dislocating many people and forcing them into lower-income communities.

4. ***HUD should avoid inducing defaults on properties that could pay their debt service even after marking to market***. As noted elsewhere, default and FHA insurance claim payments are the transaction costs intrinsic to achieving the benefits of lowering rents. Defaults and claims should be minimized. This means avoiding triggering default in any property with good chances to pay its debt service after marking to market. It also means avoiding giving lenders an option to assign *before* default unless HUD is effectively certain that default is inevitable

FUNDAMENTAL QUESTIONS AND RECOMMENDED POLICIES

Marking to market of Section 8 assisted properties involves:

- Identifying properties whose rents are above market.
- Lowering the rents and thus reducing the properties' ability to pay debt service.
- Causing or anticipating a default in the loan
- Restructuring the new lower debt service into a reconstituted or recovered mortgage.

A detailed description of the seven steps which we envision necessary for marking to market is attached as Appendix A. The procedure is also shown graphically in Exhibit 5 (graphs are to scale), which also illustrates how property-based assistance leads to greater recovery from the reconstituted mortgage A possible decision tree is presented in Exhibit 8.

At its heart, mark-to-market is a financial transaction involving a one-time investment (the net claim to the FHA insurance fund) and a long-term recovery (savings in Section 8 subsidy payments) Resolution of important policy questions in the mark-to-market approach will make billion-dollar differences in the Federal government's net cost, and can in turn determine whether marking to market makes good economic sense.

Because each property is a separate legal and economic entity, mark-to-market must be applied *property by property*. Not only does marking to market involve many policy issues, the steps in each property have an iterative component, as later steps impact on decisions made previously. Any mark-to-market strategy should be well thought through and carefully tested *before* it is implemented on thousands of properties nationwide.

In mark to market, policy questions arise at every step. Some of the key questions are listed in Exhibit 6. Questions and proposed resolutions are presented on Exhibit 7.

Among the most important issues are:

1. *Q.* ***Should below-market properties be restructured also, and if so how?***

A. *Yes*, by keeping regulation and allowing a gradual rent increase to renovate the property.

Q. ***Should below-market properties be completely deregulated?***

A. *No*. Allowing immediate deregulation costs too much and forfeits this valuable housing stock.

In particular, within the older assisted portfolio are about 350,000 good apartments whose rents are at or below market -- sometimes far below. These can be preserved for much less than the cost of Section 8 vouchers. Among these properties are the 100,000-apartment preservation pipeline properties, the best of the older affordable inventory. These can be preserved using a capital grant/loan or other mechanism.

2. *Q.* ***Are properties allowed a transition period? For how long? On what terms?***

A. *Yes*, a two to three year transition period is desirable. Allowing properties time to adjust is good economics because it will reduce Federal losses. Giving residents time to adjust is good social policy.

3. *Q.* ***Can HUD find quick and effective alternatives to its assignment procedure without opening the floodgates to FHA insurance claims that would not otherwise arise?***

A. *Yes*. An accelerated claim procedure [illegible] innovative use of private sector contractors can greatly improve results. HUD has offered intriguing initiatives in this regard.

Q. Should HUD encourage assignments before default?

A. *Not in marginal situations*. Mark-to-market is a Federal *benefit* – paying FHA insurance claims is a *cost*. HUD should try to have as few claims as possible

Lenders want to assign not just to protect their position but also to create capital gains. Many lenders hold loans with interest rates below current market; many of these were bought at a discount in the secondary market. Allowing claims on these loans will cost the Federal government substantial money, *even if the property continues to pay the same debt service as before*. These deep-discount assignment risks lie principally in the older assisted portfolio, with its very low interest loans (such as 3% Section 221(d)(3) BMIR's).

Within the newer assisted portfolio are many properties whose rents are so far above market that after mark-to-market, default is inevitable. These latent assignments can be encouraged so as to allow HUD to control the timing of default and resolution.

Also within the portfolio are many properties which *might* be able to survive at true market rents. *These* properties should not be offered advance restructuring, or the Federal government will find itself paying claims and suffering negative interest arbitrage when it had no need to do so.

4. *Q. How should HUD handle properties without FHA insurance, such as those financed by state housing finance agencies (HFA's)?*

A. *Restructure but avoid default*. Defaults on state HFA bonds could have a serious ripple effect in those states. As much as $2 billion in state HFA bonds are involved.

5. *Q. Should the new subsidy be property-based or tenant-based, and what criteria should be applied in choosing?*

A. *Property-based in most cases*. Property-based assistance is usually superior in all cases *except* fatally flawed properties or incorrigible owner/managers.

Once a property's rents have been reduced to true market, going to vouchers is incrementally more expensive. Moreover, properties with property-based assistance will be valued more highly by the capital markets, who will pay a premium for a more secure income stream. As illustrated by the typical property depicted in Exhibit 5, property-based assistance will yield greater Federal recoveries: we estimate at least $1.3 billion more[4].

[4]This hypothesis can be tested in the marketplace by offering properties on a two-tier auction, where bidders could make two bids, one based on property-based assistance, the other on Section 8 vouchers. HUD could then evaluate

In mark-to-market, blanket vouchering is a luxury Congress must do without

Further, there is little statistical evidence that vouchers are more effective, on a national portfolio level, than property-based assistance. Their appeal is chiefly anecdotal, and rests largely on experiments where they represent only a small fraction of the affordable housing demand. (At least one quarter of all vouchers in circulation are used by people simply to remain where they now live, hardly a test of their effectiveness in searching out new housing.)

Today vouchers are a solution with powerful superficial appeal -- they sound much better in theory than they work in practice. Failure rates in vouchers range from 15% to 20%, about three to four times normal market vacancy and *eight to ten times* vacancy in a typical property-based assistance property. That is hardly a success.

Voucher proponents have recommended numerous reforms to make vouchers more market-competitive. These include the repeal of take-one-take-all and the endless lease, as well as simplifying the administrative procedures. We support *all* of these measures, but vouchers cannot by themselves address all affordable housing concerns:

- Vouchers tend to income concentration in places where the government has no influence City after city has discovered that too many vouchers in circulation will cause them to gravitate into a particular neighborhood and rapidly turn it into a disinvested slum.

- Vouchers make it impossible to structure successful mixed-income communities such as exist with property-based assistance.

- Vouchers give choice to residents who now live in bad housing, but they take away security (hence they inhibit choice) for residents who now live in *good* housing With good properties outnumbering bad ones by five or ten to one, this is a bad trade for the Federal government.

- Vouchers create mobility and *compel* mobility (because they put residents at risk of eviction on economic grounds). This makes them undesirable for vulnerable populations such as the elderly, who comprise 55% of the newer assisted portfolio and 25% of the older assisted portfolio[5].

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whether the bid premium for property-based assistance was enough to justify retaining it. We believe financial analysis would consistently show that it would be

[5]Recognizing this, HUD has sought to protect the elderly with eviction-proof vouchers whose rents can rise to the property-specific rents needed to keep a resident in place -- this is property-based payment without property-based regulation.

Prudence dictates moving slowly with voucher conversions Deregulating a property entirely and converting it to Section 8 vouchers is an irrevocable action -- it cannot be reversed even if later revealed to be a mistake By contrast, continuing property-based assistance always allows the possibility of vouchering later on.

Vouchers clearly have a place in well designed affordable housing policy, and probably should have a presence in every market, if only as a check on market conditions. Nevertheless, immediate vouchering will make mark-to-market more complex and more expensive. Property-based assistance should be used unless there is a compelling reason (excessive cost, fatally flawed property or owner) to use vouchers.

6. Q. ***Will properties be renovated, and if so, where will the money come from?***

A. ***Renovations as needed can be built into the transaction.*** Some properties, chiefly those in the older affordable portfolio, will need renovations to compete

Older assisted properties: from the rent stream. Managers of properties with rents below market should be encouraged to rebuild them *using their current rent stream*. The typical property will need three to five years of internal reinvestment to achieve market competitiveness. If this is done sensibly, the end product will be a market-competitive property which *still* has rents well below market -- a true bargain in public-policy terms.

Newer assisted properties: need little renovation Except troubled or fatally flawed properties, these are in good to excellent physical condition and need little work.

If necessary, lower debt service further Properties whose earning power will not let them reinvest with operating funds will need their debt service lowered even further so as to create cash flow for working capital.

7. Q. ***What happens to the owners in ....s process?***

A. ***Good owners should buy in to the process.*** A process that leads to the owner's likely foreclosure will fail because owners will oppose it Conversely, if mark-to-market creates economic equity where none was present before, the owner must buy in with some sort of economic commitment, either cash or a meaningful deferred-payment note.

A process where capable owners can expect to survive and prosper will also benefit the Federal government: if the owner is an enemy of the process, it will mount legal and procedural defenses The owner will also have incentives to disinvest before contract expiration.

Mark-to-market will require five to seven years to implement, because contracts come up for renewal between FY 96 and FY 2002. Thus, if owners whose contracts expire several years in the future observe their counterparts being foreclosed today, they will have no incentive to sustain quality operations. The portfolio will deteriorate before it reaches mark-to-market, and Federal losses will be higher.

8. Q. ***How much resident displacement is acceptable?***

A. ***As little as possible***. Minimizing displacement should be a public-policy imperative as important as financial recovery.

9. Q. ***Will properties whose rents have been reset to true market and their debt restructured continue to be subject to HUD regulation? If so, how?***

A. ***Yes, but change the regulatory structure***. Complete deregulation forfeits good housing stock with no benefit. Continued HUD-run process-based regulation is infeasible. Substitute results-based accountability for process-oriented regulation and, if HUD is incapable or unwilling to provide regulatory oversight, devolve compliance to state or local agencies which have proven capable of handling the job.

COMMENTS ON HUD'S APPROACH TO MARK-TO-MARKET

As noted above, HUD has advanced the discussion by providing an extensive set of materials, including a preliminary operating framework, outlining its vision of how mark-to-market should be implemented.

HUD's operating framework lists a series of objectives. For the reasons outlined in this paper, we concur with all of them: HUD has identified the critical elements.

At the same time, HUD's implementation schemas are troubling in several areas where they either fail to support HUD's objectives or run counter to them. Among our most important concerns are the following:

1. HUD has made complete deregulation and immediate vouchering integral components in mark-to-market. B[illegible] are optional, not intrinsic, and are an over-reaction.

A. Complete deregulation forfeits the good properties with below-market rents. This increases costs with inadequate (if any) resulting benefit. Indeed, we can show many properties where complete deregulation would lead to an absurd result:

HUD would give the residents vouchers. The owner, unexpectedly liberated, would immediately raise rents to market. The residents, most of whom have li[illegible] the property for

many years and consider home, could use the vouchers to pay the higher rents Thus, after deregula on, HUD would be paying much more money to have the same people living in exactly the same property -- *and* the owner would be free to convert to a higher and better use wherever the market improved.

Many properties in the older assisted portfolio fall into this category, including essentially all of the LIHPRHA preservation pipeline. For these properties, other preservation solutions (such as capital grant/loan) are cheaper and better, especially in terms of long-run outlay levels

B. Immediate vouchering of above-market properties will reduce Federal recoveries on the reconstituted mortgages. Properties marked to market and immediately vouchered are essentially equivalent to new properties -- they have no relevant operating history. By contrast, properties that retain property-based assistance are much more like a net lease, with a reliable income stream (subject to collection loss if the owner does a bad job). Capital markets prefer security and pay more for it.

Immediate vouchering will likely lead to significantly lower net recoveries. Even if vouchering is a long-term goal (a conclusion we doubt), a transition period is a matter of economic necessity.

C. Extra complexity makes practical realizations lower. HUD is proposing to restructure an enormous amount of property radically and quickly. Experience shows that the more components to a restructuring, the longer it takes and the harder it is to do. We see far too little benefit from immediate deregulation and vouchering to justify the additional complexity it will entail.

2. The operating framework puts owners at high risk of foreclosure and could result in owner opposition. Among the debt restructuring mechanisms emphasized in the operating framework are so-called 'reflector' mortgages, where a new lender will buy the face amount of the current loan but at a steep discount.

Even though the typical buyer is likely to pay only about 40% of par, the borrower will still be liable for the full amount -- and have a rent stream utterly incapable of supporting that debt. This will give the new lender all the leverage

Some potential loan buyers will have no interest in foreclosing -- they will want simply to restructure the debt and keep the current owner in place. Other potential buyers will be seeking the equity upside, business opportunities associated with bulk acquisitions, or exploitation of the current owner's potential Federal income tax risk to extract a no-foreclosure premium from the owner. Buyers who want to be foreclosers will most likely outbid buyers who merely want to be lenders, so are likely to win most auctions.

Owners who fear ultimate foreclosure have no incentive to participate in the process and many incentives to thwart it. Owners also have potential legal remedies, such as bankruptcy or lender-liability lawsuits against HUD, which even if ultimately successful would slow down and

complicate HUD's asset realization strategies. Finally, the owners have done nothing wrong to put their properties into jeopardy, and indeed developed the properties initially under HUD supervision and according to HUD rules that inflated construction costs and imposed operating handicaps.

Conversely, owners who expect they can retain ownership in a fairly structured recapitalization will be motivated to improve their property and to participate effectively in the recapitalization process. Their participation will be valuable -- they know the property and its market better than anyone, and should be best placed to maximize its value.

Both fairness and economic practicality dictate that HUD's debt restructuring protocols should make it likely that capable owners will survive, and should give them some leverage to assure that this occurs.

*3. **Even if the current regulatory system is dysfunctional, it should be reformed, not abandoned**.* As noted above, complete deregulation will cost money compared with continued regulation. In other contexts, HUD has argued that deregulation is necessary because twenty years of HUD regulation have failed. Even if this is true (a conclusion which many would dispute), two changes are possible:

A. Change regulatory agents. Regulatory compliance could be devolved from HUD to state housing finance agencies (HFA's) or localities such as public housing authorities (PHA's). Devolution should be done selectively, to HFA's or PHA's with established track records. It may also involve building in a contract administration fee as a property expense. Nevertheless, it can be done, and has been done -- as demonstrated by the older assisted portfolios of capable state agencies such as Massachusetts, Michigan, Pennsylvania and Virginia.

B. Change regulatory objectives. Current regulations emphasize process -- compliance with micro-managed sequences of actions intended to produce outcomes. Better regulations emphasize results -- residents served, property physical condition, and so on. While it is often in the nature of regulators to specify processes in ever-greater detail, post-audit compliance (such as is used in Federal income tax reporting and in professional society certification) has an excellent track record.

In that regard, the Low Income Housing Tax Credit serves as an impressive experiment. Setting aside for the moment questions of cost-effectiveness, the LITC is regulated via a purely outcome-driven approach. Owners and mangers certify at year-end whether they rented to eligible residents, and if they charged rents below the LITC ceiling. They maintain detailed files documenting this compliance, which are inspected annually by tax credit allocators. The entire procedure consumes probably one-twentieth the manpower of process-oriented compliance.

Existing affordable housing could easily shirt to post-audit compliance methods.

*4. **HUD must clarify its policy imperatives***. At the heart of all debates about affordable housing lies an irreconcilable conflict between economics and policy. Every dollar of

decreased subsidy means a dollar of increased resident rent Added capital cost (or mortgage recovery) means an increase in rents

Over the last twenty years, HUD's mission has been clouded by a burgeoning set of conflicting statutes, some favoring policy, some economics In its original mark-to-market proposal, HUD made economic recovery essentially sacrosanct, and subordinated all other objectives. Since then HUD has modified its view, providing exemption for state HFA properties and protection for elderly residents. To those imperatives we think should be added two more:

- *Deal fairly with owners.* The private sector created this affordable housing, and will be called upon to recapitalize it. To ruin one group of investors at the same time HUD is encouraging another group of investors would be self-defeating.

- *Preserve the good properties.* Most of this stock is good housing. Much of it is below-market rent today. Even more will represent a favorable economic bargain once rents are lowered and debt is restructured. Not only is it necessary today, markets are fluid -- they often improve quickly -- and have been tightening for the last several years. HUD could easily regret giving away today housing that will be irreplaceable tomorrow.

CONCLUSION

The mark-to-market debate may well set the course of affordable housing policy for the next twenty years. Congress and HUD will have to evaluate all strategies on their cost-effectiveness. Because the portfolio is not homogenous, portfolio segmentation is essential -- no one strategy will work for all properties.

Eight principles should govern mark-to-market strategy development:

1. *Cut ongoing Section 8 subsidy costs.*
2. *Reduce subsidy dependency.*
3. *Restore market competitiveness.*
4. *Minimize displacement.*
5. *Deal fairly with owners and investors.*
6. *Preserve access to the capital marketplace.*
7. *Recapitalize the affordable housing stock*
8. *Cull bad owners and bad properties.*

In developing its strategy, we recommend that Congress include the following elements:

1. *Properties with rents below market should remain regulated and retain the favorable bargain Congress made twenty years ago.*
2. *Retaining property-based assistance during mark-to-market will reduce net Federal losses.*
3. *In the long run, property-based assistance is cheaper for most mark-to-market properties.*

4. *HUD should avoid inducing defaults on properties unless they are certain to need debt restructuring.*
5. *For most properties, necessary capital improvements can be funded over time through normal operations (assuming a reoriented regulatory structure).*
6. *For properties retaining property-based assistance, a reformed regulatory structure is viable and superior to complete deregulation.*
7. *Devolving regulatory responsibility to states and localities is feasible.*
8. *HUD will recover more money if owners support mark-to-market, which they will do only if HUD adopts recapitalization strategies that give capable owners some standing.*
9. *HUD must clarify its policy imperatives and priorities.*

With its operating framework, HUD has made a good start and opened a dialog. Now the responsibility lies with Congress.

Exhibits and Appendices

1. Classification and comparison of the older and newer assisted portfolios
2. Schematic representation of the universe of properties
3. Taxonomy of the older assisted portfolio -- seven categories
4. Taxonomy of the newer assisted portfolio -- five categories
5. Mark-to-market illustrative example: changes in debt service and mortgage recovery
6. Policy issues that must be addressed in each step of marking to market
7. Policy questions and recommended responses
8. HUD affordable portfolio, recapitalization decision tree

A. Marking Section 8 Rents to Market: How It Works
B. Photographs of representative older assisted properties

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Exhibit I

SECTION 8 MARK-TO-MARKET
CLASSIFICATION OF THE HUD ASSISTED PORTFOLIO

	Older Assisted Portfolio	*Newer Assisted Portfolio*
How many apartments involved	640,000	450,000
Percentage with above-market rents	25%	90%
Median rent today, percent of FMR	85%	130%
Range of rents today relative to FMR	50% to 115%	90% to 175% (or more)
When developed	1968-1976	1977-1983
Type of construction	New construction or light rehab	New construction or substantial rehab
Most common locations	Inner city, near suburbs, rural	Inner city, suburbs, rural
Original rents relative to market	Usually 10-20% below	Usually 10-40% above
HUD financing programs involved	Section 221(d)(3) and Section 236	Section 221(d)(4) (and related programs)
Typical mortgage interest rates	Below market (1%, 3%, or 7%)	Market (7½% to 9%)
Rent-setting mechanism	Budget basis (annual HUD review)	Annual Adjustment Factor (AAF)
Percentage of residents who are elderly	Originally 15%; now 25%	Originally 45%; now 55%
How much Section 8 today	65%	95%
Type of Section 8	Loan Management Set Aside (LMSA)	Annual Adjustment Factor (AAF)
Section 8 cost per apartment per year	About $3,900	About $7,500

Exhibit 2

Section 8 Mark-to-Market
The Universe of Properties, Schematic Representation

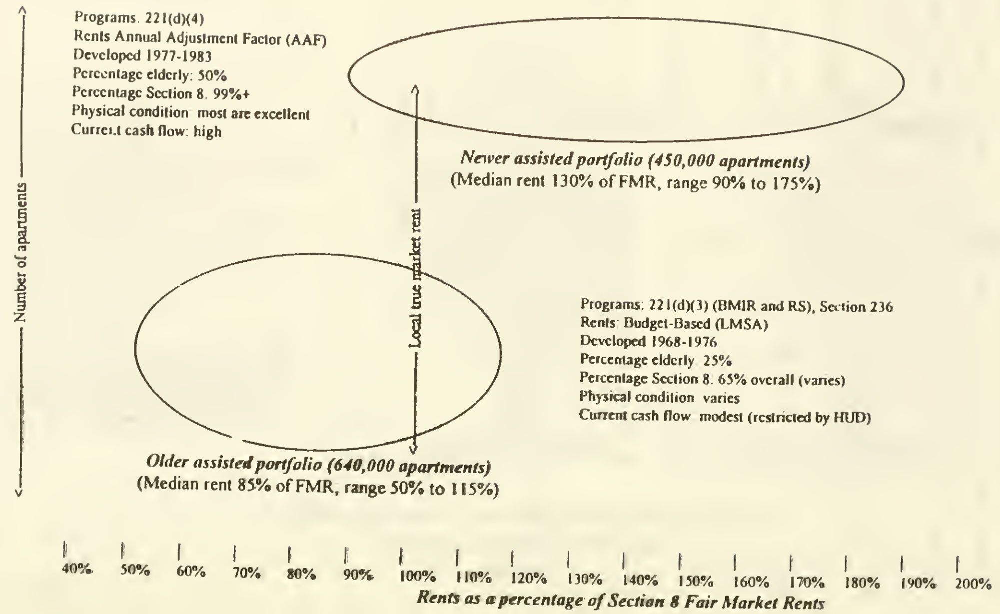

Exhibit 3

HUD OLDER ASSISTED MULTIFAMILY INVENTORY

Taxonomy and Recapitalization Strategies

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Shaded areas = Section 8 now.

		Apts	Recapitalization strategy
40% Section 8 **Above FCL**	Excellent properties, too valuable to preserve	20,000	Allow prepayment. Voucher residents.
40% Section 8 **Preservation Viable**	Good properties, able to prepay if the right to do so is restored. More cost-effective for the Federal government to preserve them than to allow prepayment.	75,000	**Preserve** Use a capital grant/ loan to keep rents low.
55% Section 8 **Rent-Suppressed**	Good properties, able to raise rents from current levels but unable to raise them high enough to overcome the cost obstacles of prepayment: renovation, conversion, and of favorable debt service on first mortgage. Some properties are experiencing functional and economic obsolescence as they age; they need non-structural renovations often averaging $2,000 to $4,000 per apartment.	125,000	**Deregulate / recapitaliz** Deregulate the operating budget so as to emphasize capital reinvestment. Allow greater cash returns to motivate owners and managers.
65% Section 8 **Equilibrium**	Properties whose current rents closely approximate their local market and neighborhood conditions. Limited ability to raise rents; occasional operating difficulty. Most properties are experiencing noticeable functional and economic obsolescence; they need greater renovations averaging $2,000 to $7,500 per apartment. Without intervention, these properties could slide into physical and operational decline.	150,000	**Deregulate / recapitaliz** Substantially deregulate the operating budget to reduce administrative and regulatory costs. Allow greater cash returns to motivate owners and managers. Encourage owner capital reinvestment.
80% Section 8 **Subsidy Dependent**	Properties now being largely supported by existing Section 8 Loan Management Set Aside (LMSA) funds. Budget-based rents required to sustain breakeven are above local market conditions. Most properties are experiencing noticeable functional and economic obsolescence; they need greater renovations averaging $2,000 to $7,500 per apartment. Without continuing Federal subsidy, these properties cannot pay their current debt service.	170,000	**Mark to Market** Reduce contract rents to true market levels. Accept mortgage defaults, pay assignment, and write down debt service to manageable new levels. Deregulate as much as possible.
90% Section 8 **Troubled**	Properties already experiencing operating difficulties. Not only are they having trouble paying full debt service, their physical condition is declining. Many are already in the HUD-held inventory.	70,000	**Mark to market workou** Reduce debt service requirements. Restructure operations. Inject capital at the margin. Motivate/enforce owner.
95% Section 8 **Fatally Flawed**	Properties with fatal defects in construction, location, operations, ownership. Reinvestment is imprudent.	30,000	**Dispose** Donate, close or demolish. Voucher residents.

Exhibit 4

HUD NEWER ASSISTED MULTIFAMILY INVENTORY 06/10/95

Taxonomy and Recapitalization Strategies

Shaded areas = Section 8 now.

	Apts	Recapitalization strategy
At or Below Market Good properties whose rents are below market today or that could support current debt service at market rents. Good or excellent physical condition.	50,000	Keep current debt Avoid triggering default which will cost money.
MARK TO MARKET Good properties with SHORT Section 8 contracts that will expire in the next few years. Current rents are above market, in some cases far above. Properties are generating cash flow, in some cases large amounts of cash flow, but if rents were reduced to true market, these properties would be unable to pay their full debt service. Because cash flow today is strong, these properties are generally in good to excellent physical condition.	280,000	MARK TO MARKET Reduce contract rents to true market levels. Accept mortgage defaults, pay assignment, and write down debt service to manageable new levels. Key principles to use: 1. Minimize claims on FHA insurance fund. 2. Maximize recovery. 3. Recapitalize property onto a stable footing. 4. Use market forces *wherever prudent.* 5. Minimize displacement 6. Deal fairly with owners 7. Cull bad owners.
Zero Cash Flow Fundamentally sound real estate but locationally impaired (weak markets, urban or rural) so that market rents do not even cover operating costs.	50,000	Support temporarily Lower rents to market. Eliminate debt service. Property-based assistanc
Troubled Operating difficulties. Loan in default or HUD held.	25,000	Work out or sell Fix the real estate.
Fatally Flawed Fatal defects in construction, location, tenancy, ownership	25,000	Give away or demolish Voucher residents.
	430,000	apartments approximately

About 55% of the newer assisted portfolio is occupied by *elderly* residents.

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Categorization estimates on this chart, and the companion chart for the older assisted portfolio, are *rough estimates* by Recap Advisors based on incomplete statistical analysis. *Boxes are to scale.*

Exhibit 5

Marking Section 8 Rents to Market

Changes in Monthly Debt Service

(Boxes reflect the proportion of monthly rent which must be dedicated to the specified use)

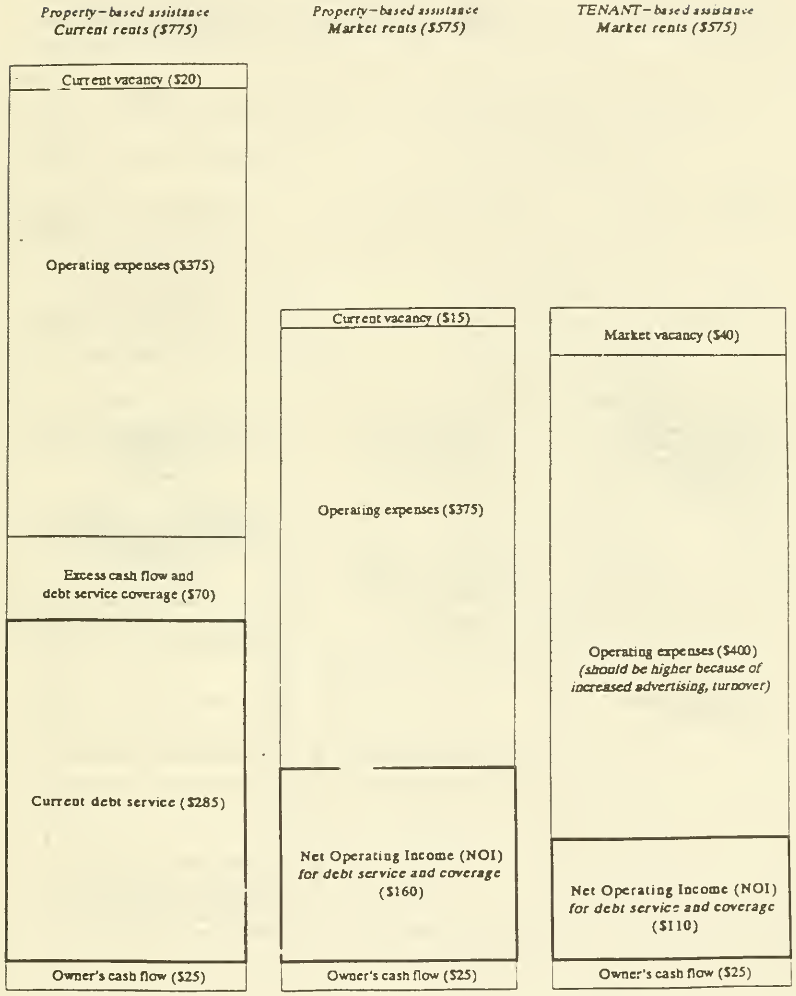

Exhibit 5

Marking Section 8 Rents to Market

Results of Re-underwriting: Mortgage Principal Writedown

(Boxes reflect the proportion of monthly rent which must be dedicated to the specified use)

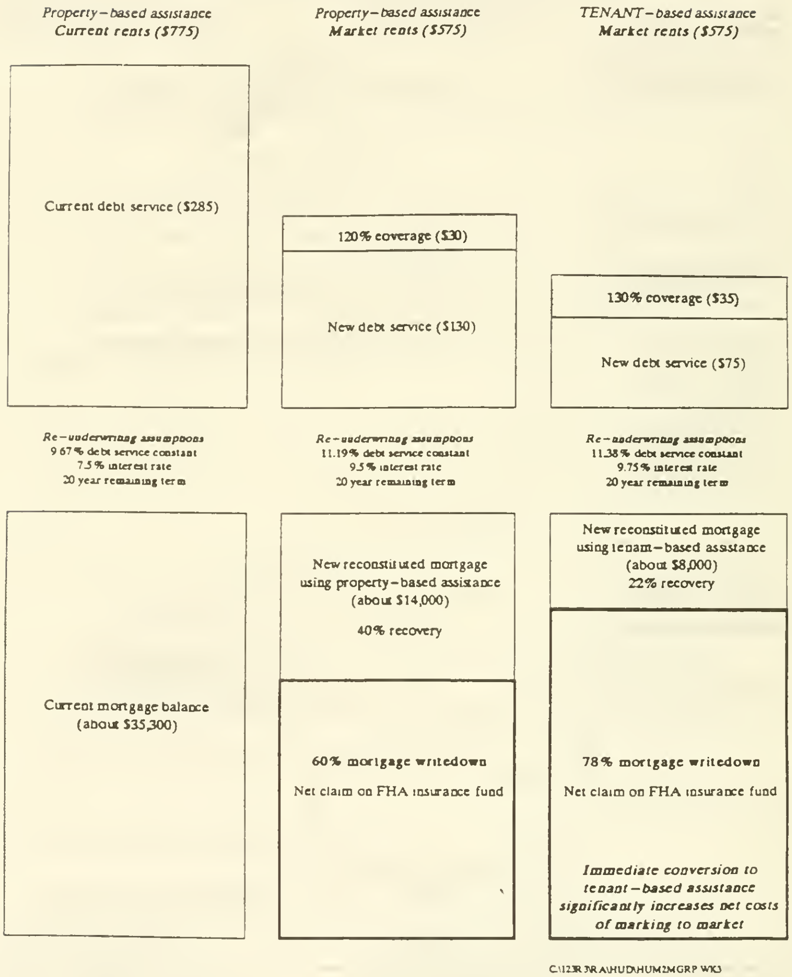

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Exhibit 6

SECTION 8 MARK TO MARKET

POLICY ISSUES THAT MUST BE ADDRESSED

Marking Section 8 rents to market involves the following seven steps. Decisions are interactive a ¦ iterative -- they affect one another -- and some combinations of answers produce *much* better results than other combinations.

Step	*Activity*	*Policy Questions Raised in this Step*
Step 1	Identify above-market properties	• Should below-market properties be restructured also, and if so, how?
Step 2	Determine new market rents	• Formula or property-specific? • Are properties allowed a transition? • Who does it?
Step 3	Satisfy old mortgagee *Absorb claim in FHA insurance fund*	• If no default, no cost to HUD. • If default, full assignment, Partial Payment of Claim, or a new hybrid? • What if mortgage has no FHA insurance (e.g. state HFA)?
Step 4	Determine new Net Operating Income	• Section 8 property- or tenant-based? • Risks of tenant displacement? • Changes in operating budget? • Need for repairs or renovations? • Should reserved be increased?
Step 5	Establish new debt service	• Protect owners' cash flow? • What level of coverage? • What happens to properties with zero cash flow?
Step 6	Price new mortgages *Restructuring or foreclosure*	• New FHA insurance or not? • What happens to reduced debt? • Are owners at risk of foreclosure? • Owners' tax consequences?
Step 7	Sell new mortgages *Recover against old claims*	• Are properties held in HUD inventory? • Who sells the loans?

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Exhibit 7

SECTION 8 MARK-TO-MARKET

PUBLIC-POLICY QUESTIONS AND RECOMMENDED POLICY

(Page 1 of 2)

Public-Policy Question	*Recommended Policy*
Should below-market properties be restructured also? If so, how?	***Yes***, by keeping regulation and allowing a gradual rent increase to renovate the property. Allowing immediate deregulation costs too much and forfeits this valuable housing stock.
Are properties allowed a transition period? For how long? On what terms?	***Yes***, a two to three year transition period is desirable Allowing properties time to adjust is good economics because it will reduce Federal losses Giving residents time to adjust is good social policy
Can HUD find quick and effective alternatives to its assignment procedure *without* opening the floodgates to FHA insurance claims that would not otherwise arise?	***Yes*** An accelerated claim procedure or innovative use of private sector contractors can greatly improve results. HUD has offered intriguing initiatives in this regard
How should HUD handle properties *without* FHA insurance, such as those financed by state housing finance agencies (HFA's)?	***Restructure but avoid default*** Defaults on state HFA bonds could have a serious ripple effect in those states
Should the new subsidy be property-based or tenant-based, and what criteria should be applied in choosing?	***Property-based in most cases*** Once a property's rents have been reduced to true market, going to vouchers is incrementally more expensive Property-based assistance is superior in all cases *except* fatally flawed properties or incorrigible owner/managers
Will properties be renovated, and if so, where will the money come from?	***Older assisted properties: from the rent stream*** These properties generally have room to increase their earning power through sensible rent increases ***Newer assisted properties: need little renovation*** Except troubled or fatally flawed properties, these are in good to excellent physical condition and need little work. ***If unavailable in the rent stream, lower debt service further***

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Exhibit 7

SECTION 8 MARK-TO-MARKET
PUBLIC-POLICY QUESTIONS AND RECOMMENDED POLICY

(Page 2 of 2)

Public-Policy Question	*Recommended Policy*
What happens to the owners in this process?	***Good owners should buy in to the process*** A process that leads to the owner's likely foreclosure will fail because owners will oppose it. Conversely, if mark-to-market creates economic equity where none was present before, the owner must buy in with some sort of economic commitment, either cash or a meaningful deferred-payment note
How much resident displacement is acceptable?	***As little as possible*** Minimizing displacement should be a public-policy imperative as important as financial recovery
Will properties whose rents have been reset to true market and their debt restructured continue to be subject to HUD regulation? If so, how?	***Yes, but change the regulatory structure*** Complete deregulation forfeits good housing stock with no benefit. Continued HUD-run process-based regulation is infeasible Substitute results-based accountability for process-oriented regulation and, if HUD is incapable or unwilling to provide regulatory oversight, devolve compliance to state or local agencies which have proven capable of handling the job

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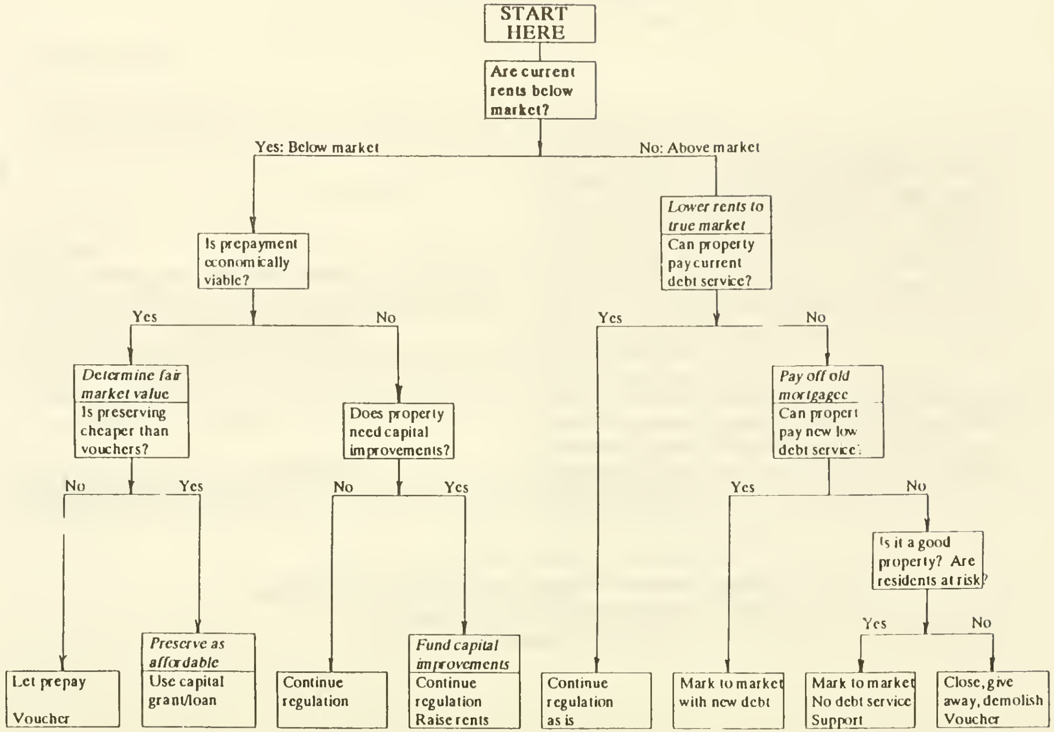
Exhibit 8

HUD Existing Affordable Portfolio Recapitalization Decision Tree



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APPENDIX A

MARKING SECTION 8 RENTS TO MARKET
HOW IT WORKS

SUMMARY

Marking to market of Section 8 assisted properties involves

- Identifying properties whose rents are above market.
- Lowering the rents and thus reducing the properties' ability to pay debt service.
- Causing or anticipating a default in the loan.
- Restructuring the new lower debt service into a reconstituted or recovered mortgage

At its heart, mark-to-market is a financial transaction involving a one-time investment (the net claim to the FHA insurance fund) and a long-term recovery (savings in Section 8 subsidy payments). Resolution of important policy questions in the mark-to-market approach will make billion-dollar differences in the Federal government's net cost, and can in turn determine whether marking to market makes good economic sense

This memorandum describes the Administration's proposed procedure by which properties could be marked to market and, in so doing, identifies the key policy questions whose answers will dictate the Federal government's net costs

MARKING AN INDIVIDUAL PROPERTY TO MARKET

Because each property is a separate legal and economic entity, mark-to-market must be applied *property by property*, via a procedure that involves seven basic steps:

Step 1: Identify properties with above-market rents Those whose current rents are below market will be culled from this process (although they may be subject to other deregulation or rent restructuring under a different programmatic approach)

Step 2: Establish new (lower) market rents. The property's rents must reflect actual market conditions: if they are too high, the Federal government will continue oversubsidizing the property; if too low, the mortgage writedown will be unnecessarily expensive. At the same time, the properties have had many years of insulation from the market, so they may lack operating practice that would strengthen their market position. Finally, market rents are location-specific -- within a given Metropolitan Statistical Area (MSA) may be a dozen distinct submarkets with different rent levels. If the underwriting is done property by property, it requires enormous resources and careful diligence which slows disposition. Conversely, if it is done broadly, applying a general formula (such as Section 8 Fair Market Rents), it risks inaccuracy.

Step 3: Satisfy the current mortgagee. A few properties whose current rents are above market have enough cash flow to keep paying their current debt service even after the rent reduction. Nevertheless, most do not: reducing their rents will make the property unable to service its debt and will give the FHA-insured mortgagee the right to assign the loan (for 99% of par), which it will probably elect (because most of these loans carry below-market interest rates).

If the mortgage lacks FHA insurance (such as many state housing finance agency or local tax-exempt 11(b) bond properties), the issues become more complicated since a third-party mortgagee is involved. No methodology has yet been identified to handle these properties equitably.

Step 4: Determining the new Net Operating Income. Once the new rents are set, the property's ability to pay debt service depends on its new Net Operating Income, which takes into consideration vacancy, operating expenses, reserves and renovation, and the owner's cash flow. Each of these raises issues, as follows:

- *Vacancy*: If the Section 8 assistance remains property-based, vacancy will probably remain unchanged at its current low levels. If the Section 8 becomes tenant-based, vacancy will rise to market levels. If there is *no* replacement Section 8 at all, vacancy and displacement will be huge.

- *Operating expenses*: Properties insulated from the market may have some less than optimal practices. Conversely, they have little if any advertising and renting costs, and lower turnover (an expensive category).

- *Reserves and renovation*: Older properties with dividend limitations and budget-based rents often have done less ongoing renovation, because the current system actively discourages it. If these properties are to compete effectively in the market, they will need renovations. Older properties also have rising ongoing replacement requirements, so their reserve deposits should also rise.

- *Owners' cash flow*: Essential to the success of marking to market will be to secure the cooperation and economic motivation of owners; failure to do so will substantially increase claims to the FHA insurance fund. Hence the owner should have a reasonable expectation of generating cash flow after the recapitalization.

Step 5: Establish new debt service Net Operating Income never translates dollar-for-dollar into new debt service -- lenders require a bit of 'debt service coverage' (typically ranging from 110% to 140%). If the reunderwriting has no FHA insurance, the coverage must be greater So NOI must be reduced by coverage to establish a suitable new debt service level

Some properties will have no ability, initially or even after repositioning, to generate debt service. A few of these properties deserve to be closed or demolished Many others simply suffer the misfortune of being located in areas with low market rents (inner cities or rural locations) Many of these should be kept open, because they are good properties and the marginal cost to do so is small. Provision should be built into the system for coping with such properties.

Step 6: Structure the new mortgage. Structuring the new mortgage involves determining the interest rate, remaining term, and the FHA insurance. This step interrelates with the preceding one, since lenders who are highly confident of repayment will require a lower interest rate and lower debt service coverage, hence pay a higher price.

As noted in Step 3 above, uninsured mortgages complicate the picture and have not yet been addressed

Step 7: Sell the new mortgages Under current procedures, HUD becomes the mortgagee and holds the loan while it internally attempts to restructure it. This process has historically taken a long time (15 months is typical) and costs HUD large holding period costs. Finding a transaction which pays the mortgagee in full but prevents the loan actually coming into the HUD inventory would significantly reduce the FHA insurance fund's net costs. So would having access to capable private-sector financiers and mortgage underwriters

The preceding discussion should illuminate that not only does marking to market involve many policy issues, the steps in each property have an iterative component, as later steps impact on decisions made previously. Any mark-to-market strategy should be well thought through and carefully tested *before* it is implemented on thousands of properties nationwide

PRINCIPAL ISSUES THAT ARISE IN MARKING TO MARKET

The following table illustrates the principal issues that arise in each of the seven steps. (As noted above, these decisions are interactive and iterative -- they affect each other.)

Step	*Activity*	*Policy Questions Raised in this Step*
Step 1	Identify above-market properties	• Should below-market properties be restructured also, and if so, how?
Step 2	Determine new market rents	• Formula or property-specific? • Are properties allowed a transition? • Who does it?

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Step	Activity	Policy Questions Raised in this Step
Step 3	Satisfy old mortgagee *Absorb claim in FHA insurance fund*	• If no default, no cost to HUD • If default, full assignment, Partial Payment of Claim, or a new hybrid? • What if mortgage has no FHA insurance (e g state HFA)?
Step 4	Determine new Net Operating Income	• Section 8 property- or tenant-based? • Changes in operating budget? • Need for repairs or renovations? • Increased reserves?
Step 5	Establish new debt service	• Protect owners' cash flow? • What level of coverage? • What happens to properties with zero cash flow?
Step 6	Price new mortgages	• New FHA insurance or not? • What happens to reduced debt? • Owners' tax consequences?
Step 7	Sell new mortgages *Recover against old claims*	• Are properties held in HUD inventory? • Who sells the loans?

OTHER IMPORTANT CONSIDERATIONS

In addition to the financial questions are other important considerations such as.

- Will this 'purely financial' transaction have operational consequences that impair owners' contract rights or disrupt the residents' quality of life?
- Can this restructuring be managed without legal consequences to the Federal government? Specifically, what are the risks of litigation by owners, lenders, residents, or communities?
- Will the financial restructuring (and owners' efforts to compensate for lost revenue) trigger a cascading effect whereby property operations suffer, leading to losses greater than suggested by a 'hold harmless' approach?
- Will properties that have had their rents reset to true market and their debt restructured continue to be subject to HUD regulation? If so, how?
- How will the debt writedown be handled? Will it survive as an accruing mortgage? If not, how do owners avoid Federal income taxes on cancellation of indebtedness? Conversely, if it *does* survive, how will HUD motivate owners and managers to maintain and improve the properties?

CONCLUSION

Mark-to-market involves a radical overhaul of as many as 5,000 HUD-insured and HUD-assisted properties nationwide, representing a total inventory of $15 billion in FHA insurance Financial consequences will run into billions of dollars Some mark-to-market approaches make significantly more economic sense than others Any proposed mark-to-market and reunderwriting structure should be tested against portfolios of sample properties to determine the projected consequences to the FHA insurance fund

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TESTIMONY BEFORE U.S. SENATE SUBCOMMITTEE ON HOUSING OPPORTUNITY AND COMMUNITY DEVELOPMENT REGARDING HUD'S "MARK-TO-MARKET" PROPOSAL

By: William E. Haynsworth, Senior Vice President
The Boston Financial Group, Boston, MA 02110
June 15, 1995

Mr. Chairman and Members of the Subcommittee:

Thank you for giving me this opportunity to share my views on HUD's proposed restructuring of the Multifamily Insured/Assisted Housing Portfolio otherwise known as "Mark-to-Market." I am a Senior Vice President of Boston Financial which is a national real estate investment firm founded in 1969. For the past 25 years, the firm has focused its efforts in the multi-family housing industry. We currently provide asset management or property management services to more than 240 properties containing more than 30,000 apartment units which receive project-based Section 8 subsidies. We also represent more than 36,000 owner/investors who invested in these properties. At Boston Financial I am primarily responsible for the structuring of real estate investments and the acquisition of new property interests. Prior to joining the company in 1977, I served as Acting Executive Director and General Counsel of The Massachusetts Housing Finance Agency.

Having worked with HUD for a long period of time, Boston Financial has great respect for the Department as an institution and for its people. We look forward to working with HUD on its mission to improve cost effectiveness and quality of its operations and programs. We agree with certain of the core drivers of Mark-to-Market, mainly that the cost effectiveness of housing programs will be improved by adding greater market incentives. However, we also believe that great care needs to be given before dismantling programs that currently support about 800,000 apartment units. HUD needs to carefully consider all of the constituencies which will be impacted by its proposed changes. These include, among others, tenants, owner/investors, managers, public housing authorities and bond holders.

Boston Financial is a member of a number of industry groups and we generally endorse the "Proposal to Address Expiring Section 8 Contracts on Properties with FHA-Insured Mortgages" recently released by National Leased Housing Association and others. Although my comments will touch a number of concerns, Boston Financial is primarily an investment and property management firm. We believe that the cooperation of owner/investors is critical to the overall success of the transition to Mark-to-Market. I will focus my comments today on two issues which are of great importance to owner/investors and therefore to the successful implementation of Mark-to-Market:

1. Congress should ensure that the debt restructurings proposed in Mark-to-Market not result in a taxable event to owner/investors.

2. HUD should have the flexibility to address the special needs of decent, well maintained affordable housing properties in particularly difficult areas.

<u>Avoid Unintended Tax Consequences</u>

A key assumption underlying Mark-to-Market is that the private sector will play an important role in its implementation. Boston Financial represents thousands of owners who invested over the past three decades in these properties in reliance upon the government's commitment to its programs. The Department now argues that many of these programs are "flawed" because the subsidized rents exceed fair market rents (FMRs). HUD states that the biggest "mistake" made was the interdependence of Section 8 rents and insured debt. In truth, many of these properties were developed in difficult areas

(inner cities) or to provide housing to particularly needy groups. In order to attract private capital to these properties it was necessary and understood by all parties that in many cases additional debt financing and Section 8 rents exceeding FMRs be available. HUD designed these programs to attract capital and develop housing. These programs worked; properties were developed and billions of dollars of private capital was invested in reliance upon the federal government's commitment to its programs. We believe that the Department will seriously undermine its restructuring effort if it does not give adequate consideration to its current partners.

An issue which has not received sufficient attention in the Mark-to-Market debate is the tax impact on current owner/investors as a result of the proposed mortgage restructurings. Debt forgiven by a lender is generally treated as taxable income to the borrower. HUD has stated that tax issues should be left to the private sector and in a "mortgage loan sale resolution, winning bidders would determine with owners how to resolve outstanding tax issues." HUD is not proposing amendments to the tax code, citing the potential for "unintended consequences." Failure to deal with this issue is likely to result in a lack of cooperation by owner/investors in the Mark-to-Market transition.

Boston Financial believes that Congress must act to ensure that proposed debt restructurings will not result in a taxable event. We strongly recommend that a change should be made to the tax code to waive the tax due on the forgiven indebtedness. An intermediate position would be to allow for the deferral of such income until the owner/investor sells or otherwise disposes of its interest in the property. Such a provision would be similar to Section 108 of the current tax code which allows for deferral of this type of income in certain mortgage restructurings. Section 108 is not broad enough to protect most HUD owner/investors because it limits the deferral to the remaining tax basis of depreciable property. Most HUD properties will not have sufficient remaining depreciable basis to take full advantage of this provision.

Another solution which has been suggested is, in the absence of a change to the tax code, to convert the existing debt not serviced under Mark-to-Market to a "soft" second mortgage. We see two problems with this approach. First, the second mortgage may be so soft that it will not be considered qualifying debt. Hence, it may not prevent triggering recognition of income from debt forgiveness. Second, such a mortgage may result in lack of sufficient financial incentives for owners. If HUD retains all the "upside", this would undermine an important market-driven incentive which is the core of Mark-to-Market.

The support and cooperation of owners is critical to the cost-effective implementation of any changes proposed by HUD. A successful and smooth transition to a market-driven concept will require that current owners have the proper incentives. If done correctly, owners' incentives can be aligned well with that of residents and government, thereby harnessing the power of market forces and ensuring a successful transition. If done incorrectly, not only will HUD meet stiff resistance from owners, but it will also lose credibility which will dramatically increase the cost of doing business with private sector participants in the future. At the least, any hope of an effective implementation of a proactive resolution of mortgages prior to default will be frustrated. Without an effective solution to the debt forgiveness problem, owners and investors will resist and fight, rather than support and cooperate, with resultant unnecessary and destructive delays and disinvestment.

Glenfield Apartments is an example of a property which can make a successful transition to Mark-to-Market if (1) the process is handled well and appropriately, and (2) we -- Congress, industry, HUD -- jointly develop a mechanism to address investors' tax consequences so that owners cooperate in an orderly and efficient restructuring of the property's finances. Glenfield is a 104-unit garden-style Section 8 apartment property located in Orangeburg, South Carolina. (A Boston Financial affiliate serves as the general partner of the partnership which owns the property, and our property management unit acts as manager of the property.) It was built in 1981 with a HUD insured mortgage and over $800,000 in equity from 15 individual investors. The property is located in a modest neighborhood near both residential and commercial properties.

Market rents in Glenfield's area are well below the property's current section 8 rents. This is largely because Glenfield is much better housing than most of its neighbors. It's not luxurious, but it is well-maintained and in good condition, unlike many of the other multifamily properties in the area.

Replacing the property's current project-based section 8 subsidies with tenant-based assistance pegged to current market rents would reduce the property's revenue by approximately $200,000 a year, more than 30%. This estimate assumes that 90% of the residents would be eligible for vouchers, and would choose to use their vouchers at Glenfield rather than take them elsewhere. This assumption is based on the good quality of Glenfield relative to competitors.

With greatly reduced rental revenues, Glenfield would only be able to support a mortgage of approximately $320,000. This means an enormous write-down of the current debt of $2.4 million.

The impact of these numbers depends entirely on how Mark-to-Market is implemented. If HUD moves directly to tenant-based assistance upon termination of the section 8 contract, with no prior action to address the particular issues of this property, the results could be disastrous. With reduced rental income, and the prospect of the sale of the defaulted mortgage loan to a private lender who would be in a position to readily foreclose, the owners would have no choice but to stop paying the mortgage and would have every incentive to stop putting money back into the property. The loan's new owner would either foreclose or restructure the mortgage with the owner, but in the months and years it took for these outcomes to sort themselves out, conditions at the property would deteriorate rapidly, and residents would face a great deal of uncertainty about the property's future ownership and management. Upon a foreclosure, the current owners would lose their $820,000 investment, as well as face a tax bill of approximately $500,000.

We recommend that HUD and its agents or partners work cooperatively with lenders and owners in advance of the expiration of the section 8 contracts to avoid these disruptive results and achieve the main goals of Mark-to-Market -- properties operating efficiently as a result of exposure to market incentives. If all parties work together, the mortgage loan can be reduced to a level that the new rents can support so that there is no need for default and disinvestment on the part of the owners. The owners will have an incentive to continue to maintain the property and operate efficiently, in that increased

occupancy and reduced expenses will translate into cash return. In other words, market incentives will be working.

There is one major catch, here, however. Under current tax laws, the $2.1 million write-down of Glenfield's debt would create paper income for investors, who would thereby incur a tax liability. As a result of Section 108 of the tax code (discussed above), the impact of this write-down is less severe than it would be in the case of a foreclosure. But investors would still be facing a tax bill of nearly $200,000, or $20,000 for each investor. Mark-to-Market would provide them with no cash with which to pay these bills.

To gain the cooperation of investors and owners for an orderly restructuring, these tax consequences must be addressed. Investors will generally be unwilling to cooperate in a process that requires them to write large checks -- especially since these checks do nothing to enhance the value of their investment.

This is why we propose elimination, or at least deferral, of the tax consequences of the mortgage write-down. Eliminating or deferring the tax to the time originally envisioned will not cause adverse budgetary consequences, as neither the budget or HUD's proposal have been counting on these tax revenues.

Special Consideration for Difficult Properties/Flexibility

In reviewing the portfolio HUD will find that there are a significant number of decent, well-maintained affordable properties which if Mark-to-Market is implemented, will not work because market-level revenues will not cover operating expenses, even in the absence of debt service. Generally, these properties serve families in tougher inner city areas and have very high operating costs as a result of security and maintenance needs. As in the case of housing for the elderly and disabled, these properties should be given special considerations. These properties provide an important resource; marking them to market without special considerations will result in large-scale loss of decent, well-maintained affordable housing in difficult areas.

Another group of properties which need special handling to survive a Mark-to-Market transition are properties like Warrington Village, a 200 unit Section 8 property located in Pensacola, Florida. (A Boston Financial affiliate serves as the general partner of the partnership which owns the property, and our property management unit acts as manager of the property.) We believe that if Warrington were to lose its project-based Section 8, it would have difficulty retaining tenants, fall into disrepair and ultimately be lost from the national housing stock.

The property is one of the few well-maintained structures in the area, and is a safe place to live relative to other properties in the area. The property is located on the poorer side of Pensacola, near schools, a small shopping center, and residential properties. However, the market is a very distressed neighborhood where crime and drugs are constant concerns. The residential properties nearby were built in the 1950's and are distressed.

FMRs in the area are actually above Warrington's rents. However, we believe that there would be considerable tenant loss once Section 8 assistance is converted to vouchers due to the location of the property in a depressed neighborhood. We suspect that most

tenants, given a voucher and the possibility of mobility, would try to move up into better neighboring areas. Clearly not all tenants will leave, and some will be replaced as other low-income households without subsidy move in, but overall occupancy is likely to fall dramatically. If occupancy falls by 40%, there will be no income to support debt service.

Given this uncertainty, it is likely that the private markets would value the mortgage loan at $0, and the FHA insurance fund would take the maximum hit. Moreover, it is likely that revenues at the property would not be sufficient to cover basic operating expenses. There would be no incentive to put any money into the property and the buildings would deteriorate rapidly, resulting in further tenant loss, disinvestment and ultimately the loss of a decent affordable housing structure, and further deterioration of the area.

Investors/owners as well as residents and the neighborhood would suffer from this result. If the property is foreclosed, investors would lose their $1.49 million investment and face a tax liability of up to $1 million.

Warrington and other properties like it pose a dilemma. To achieve resident mobility, we risk losing good, solid, affordable housing and further destabilizing distressed areas. To avoid this risk, we recommend that, in cases like this, HUD maintain some level of flexibility, so that judgment can be used to decide whether or not it makes sense to retain project-based assistance or use other incentives and tools.

Summary

In summary, we believe that the cooperation of owner/investors is a critical element in the Mark-to-Market transition. In order to obtain this cooperation, the government must carefully consider the concerns of this group. Secondly, implementation of Mark-to-Market will be far more successful if the government demonstrates some flexibility in its approach, particularly with respect to special needs properties located in more difficult areas.

Thank you for allowing me the opportunity today to share my views on Mark-to-Market.

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Glenfield

I. When Section 8 contracts expire, if rents are reduced to FMR, overall the property would show a total reduction of $156,480, <u>before occupancy losses</u>.

	Current Section 8 Rent (Monthly)	FMR	# of Units	Annual Revenue @ Sect 8 Rents,100 % occ.	FMR Annual Revenue	Annual $ Reduction (Current to FMR)	
1 bdr	447	301	32	171,648	115,584	-56,064	
2 bdr	467	347	64	358,656	266,496	-92,160	
3 bdr	520	434	8	49,920	41,664	-8,256	
			104	580,224	423,744	-156,480	*Total Annual Reduction in Rents*

II. With the shift to vouchers, we assume occupancy goes down by 10% bringing the total reduction in rents to $198,854.

FMR Annual Revenue	423,744		
10% Estimated Reduction	42,374	-198,854	*Total Reduction + Additional $42,374 Reduction for Vacancy*

III. This reduction in rents is subtracted from the 1994 NOI (Net Operating Income = net income before debt) and yields a new NOI of $46,977.

1994 NOI	245,831	
Reduction in Rents	-198,854	
New NOI	46,977	*New NOI before coverage ratio*

IV. Using current underwriting standards of a 1.3 coverage ratio, the amount of NOI available to support debt is reduced to $36,136; and using an 11.19% debt service constant, 9.5% interest rate, and 20 year remaining term, the total amount of supportable debt is $322,930.

Coverage Ratio	130%	
	36,136	*NOI Available to Support Debt*
NOI available divided by 11.19% debt serv[illegible]t	322,930	*Total Amount of Supportable Debt*

V. With an outstanding mortgage balance of $2,401,007 the mortgage would have to be reduced by $2,078,077 to match the amount of supportable debt.

2,401,007	*1994 mortgage balance*
322,930	*Amount of supportable debt*
2,078,077	*Mortgage reduction required for $322,930*

Warrington

I. When Section 8 contracts expire, rents will be in this case increased to FMR and overall the property would show a total increase of $125,952, if occupancy remains at near 100%.

	Current Section 8 Rent (Monthly)	FMR	# of Units	Annual Revenue @ Sect 8 Rents,100 % occ	FMR Annual Revenue	Annual $ Increase (Current to Market)	
1 bdr	373	381	16	71,616	73,152	1,536	
2 bdr	412	428	120	593,280	616,320	23,040	
3 bdr	457	589	64	350,976	452,352	101,376	
Totals			200	1,015,872	1,141,824	125,952	*Total Annual Increase in Rents*

II. But occupancy is unlikely to remain high. If more than 40% of tenants move once they are given vouchers and mobility and they are not replaced, the property will be unable to support <u>*any*</u> *amount of debt, and further vacancies will mean the property cannot even cover its operating expenses.*

FMR Annual Revenue	1,141,824		
39.62% Reduction in tenants	452,406	-326,454	*Total Reduction + Additional*
		$452,406	*Reduction for Vacancy*

1994 NOI	326,454	
Reduction in Rents	-326,454	
New NOI	0	*New NOI*

NO DEBT SUPPORTABLE

U. S. Department of Housing and Urban Development
Washington, D.C 20410-0000

AUG 9 1995

Honorable Alfonse M. D'Amato
Chairman, Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

I am writing you to express my support of your efforts to examine the U.S. Department of Housing and Urban Development's (HUD) "mark-to-market" proposal, and to offer any further assistance we can provide you in addressing the problems facing HUD's assisted multifamily housing programs.

Also, I have enclosed our response to Senator Connie Mack's questions for the record, as related to the "mark-to-market" hearing on June 15, 1995.

Thank you for including our office in the debate on "mark-to-market". We look forward to working with the Committee and your staff in resolving the issues which have surfaced with HUD's proposal.

Sincerely,

Susan Gaffney
Inspector General

Enclosure

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM SUSAN GAFFNEY

Q.1.a. Does HUD have the structure in place to ensure that "mark-to-market" is implemented correctly and that the interests of the residents and communities will be addressed?

A.1.a. HUD does not yet have a structure fully in place to implement "mark-to-market," but we believe they are proceeding in the right direction in designing such a structure. The design and implementation of an adequate structure is impacted by both limitations on HUD's capacity and a lack of necessary data for fully understanding the implications of mark-to-market on project residents, owners, communities, and HUD. While these problems pose a major concern in proceeding with the mark-to-market strategy, we believe the impact of these conditions on the status quo poses an even greater concern in terms of long-term program cost increases and, declining resident and community living conditions.

On the issue of capacity, HUD does possess some of the needed expertise and tools to implement mark-to-market, but the depth of HUD's capacity is severely limited for carrying out many aspects of their proposal. Therefore, the structure of the mark-to-market approach is being designed to place heavy reliance on the use of third party contractors and joint venture partner participation. The key to a successful implementation will be designing and implementing procedures that include sufficient management controls—including adequate performance incentives and measures—to assure that HUD's limited staff can monitor and manage the process, especially as it relates to third party contractors or partners. A cadre of career staff should be assigned to complete and implement this structure over the long term. They need to be equipped with the latest in computer technology because the processes are basically information driven. They need to have contract expertise because many critical service type functions will be outsourced. They need to be empowered to get the job done without political interference or administrative impediments.

HUD is also seriously hampered by the lack of necessary or reliable data for more fully understanding the implications of mark-to-market, and any needed variables in the program design. To compensate for this lack of information, HUD has initiated a major short-term study to assess the impact of mark-to-market under varying program and market conditions. A longer term data systems design and implementation effort is also needed and underway to effectively manage the program and its impacts in the future.

Q.1.b. What safeguards should HUD consider in its "mark-to-market" design that addresses the interests of the taxpayers, the residents, and communities?

A.1.b. The interests of tenants must be the first concern in the design of the mark-to-market proposal. HUD must ensure residents that will be effected by mark-to-market will be able to live in quality, affordable housing without bringing any other undue hardship upon their lives. Having a private sector partner administer such public purpose goals must be carefully done and closely monitored by HUD. Fair treatment of residents will require a design that en-

sures tenants have reasonable housing choices that are affordable while they are being transitioned into HUD's new assistance programs such as the Housing Certificate Fund.

Community interests should be protected by allowing States, cities, or counties flexibility in the use of other HUD housing and community development programs to enable them to target such other funding to stabilize or improve those areas effected by mark-to-market. Local governments and citizens should be empowered to make the choices on how best to address their low-income housing and community development needs.

The staggering costs involved with HUD's assisted housing programs puts the taxpayers at substantial risk when implementing mark-to-market. Controls must be put in place to ensure that claims against the FHA insurance fund are minimized, costs to rehab projects are reasonable, and that proposed elderly housing rent subsidies in excess of Fair Market Rents are reasonable. To the extent HUD utilizes joint venture partners to assist in the resolution of mortgages, design controls must be present that will truly share the financial risks between HUD and the joint venture partners. Safeguards are needed to ensure joint venture partners are performing services in a way that protects HUD's financial interests. When contractors are used by HUD to perform services related to resolution and rehab activities, procurement and contract management policies and controls will be important to ensure HUD's costs are minimized and reasonable when repairing projects, and returns are maximized when selling off assets. Establishing baselines for deciding when to rehab and when not to rehab, and for determining values for the resolution of mortgages will also be critical.

Q.2. It is my understanding that HUD's estimates on the potential budgetary cost of its proposal has changed several times. What caused these changes?

A.2. The changes in the potential costs of the mark-to-market proposal are factors of changes to both the operating framework for the proposal and the completeness and quality of data being used to cost out the proposal. As the process for resolving this portfolio has evolved—including provisions to protect tenants—the assumptions used in estimating the costs have changed. Also, the data needed to cost out the proposal has not always been readily accessible or reliable. As HUD continues to collect additional data, and to verify the existing data being used in estimating the costs of mark-to-market, the numbers have and will likely continue to change with increased precision.

Q.3. If HUD were to go to a "proactive" mortgage resolution strategy, i.e., using joint ventures, what issues should be addressed in designing and implementing such a strategy?

A.3. As suggested in Answer 1 above, HUD will need to design such partnerships in a way that will provide the greatest incentive for its partners to minimize the financial loss to the FHA fund without HUD needing to examine every transaction prior to it taking place. The joint venture partners need to have a financial stake in the processing of the resolution of mortgages. The risk needs to be more than a lowering of the amounts the partners may earn. To

be true partners, the partners must be at risk of losing their own capital if their performance goes below a pre-established baseline. Partners need also to be selected on a competitive basis to ensure the most capable entities are selected, and at the best price for HUD.

Q.4. You stated in your testimony that under HUD's proposed "proactive" resolution strategy, your office was concerned about the high level of vulnerability to loss that is associated with this relatively untried concept. Please elaborate on why your office is so concerned.

A.4. HUD has little relevant experience with the concept or practice of joint ventures. This makes HUD vulnerable. HUD has experienced some failures in the past when attempting to employ the private sector to carry out its responsibilities, e.g., the multifamily coinsurance program. Joint ventures in the mark-to-market proposal place a great amount of reliance upon the partner to protect HUD's interests in a multibillion dollar business and social endeavor. The private sector is also inexperienced in dealing with the resolution of a portfolio of this type, given its social program ties. Also, the capital market dynamics associated with this proposal require quick responses which HUD is unaccustomed to dealing with. Slow reactions could prove costly.

Q.5. What problems might occur over the next several weeks or months if no legislative action is taken? What kind of short-term legislative changes could policymakers consider that will mitigate any harm to the HUD inventory?

A.5. A realistic budget outlook indicates that staff capacity will diminish significantly in the short and long term. Steps need to be taken before the current values associated with HUD's portfolio decrease dramatically because of servicing inattention. HUD needs to take whatever steps are available to reduce the size of its portfolio to level off the imbalance between workload and resources.

Since HUD and many in Congress have indicated that the status quo will not prevail in the mark-to-market portfolio, the value of these properties has been effected. This loss in value will likely result in a corresponding disinvestment by some owners. Reduced rents will translate into a loss in equity position, reduction in available cash for distributions, and/or decreased fees for managing the properties, all of which provide disincentives for owners to continue to meet their project financial and maintenance obligations. This then would result in yet further reductions in value and increased losses to the Government. Delays in making the transition from project based to market based will therefore further jeopardize the taxpayers' investment in these properties.

In the meantime, HUD is already facing projects that have Section 8 contracts which are about to expire. A decision must be made on how to handle these projects, now. No decision for change will result in the continuance of excessive rents and/or substandard living conditions for residences in many cases.

If short-term legislative changes are all that is available, consideration should be given to requiring HUD to renew contracts at no higher then rent levels at comparable unassisted projects, for only short terms, and never in cases where the housing does not provide

decent, safe, and sanitary housing. If renewals are not possible under these circumstances, HUD should be permitted to provide the eligible residents with housing certificates, in lieu of further project based assistance.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM JIM WELLS

Q.1. ***Oversight of "Mark-to-Market"***—HUD has admitted that it does not have the in-house capacity to implement "mark-to-market" and therefore has developed a framework that would rely heavily on the private sector. Even though the private sector would be primarily responsible for the actual resolution of this portfolio, HUD would still be responsible for designing and overseeing the implementation of "mark-to-market." Does HUD have the structure in place to ensure that "mark-to-market" is implemented correctly and that the interests of the residents and communities will be addressed? What safeguards should HUD consider in its "mark-to-market" design that address the interests of the taxpayers, the residents, and communities?

A.1. As HUD develops its mark-to-market proposal further, it will be important for the Department to also define its proposed implementation structure so that the Congress can consider the adequacy of that framework. Currently, HUD is examining various implementation options for its mark-to-market proposal, but has not yet fully developed either the proposal or the implementation framework.

HUD's mark-to-market proposal is aimed primarily at (1) eliminating the excessive section 8 subsidy costs currently borne by U.S. taxpayers and (2) giving low-income tenants increased residential choices. However, if mark-to-market is not implemented properly, the taxpayers could continue to pay excessive costs and low-income residents could be displaced. For example, one of the potential risks of the mark-to-market proposal is that the Government could provide excessive benefits to property owners or other parties at the expense of U.S. taxpayers. HUD's proposal should incorporate proper controls and oversight over the property/note sales and clearly define the ways in which the proposal will address and balance the interests of taxpayers, residents, and communities.

Q.2. ***FHA Loan Loss Reserve***—For fiscal year 1994, HUD had set aside a loan loss reserve of $9.5 billion to cover expected future losses in its insured multifamily portfolio. Most predict that "mark-to-market" would result in a substantial number of defaults and claims paid out of FHA insurance funds. Is the $9.5 billion loan loss reserve adequate to cover the losses that may result from HUD's "mark-to-market"? If not, how much more Is needed to cover the "mark-to-market" losses?

A.2. The loan loss reserve estimate assumes the continuation of Section 8 project-based subsidies at the current levels and thus does not take into account the effect of marking-to-market. Consequently, HUD's mark-to-market proposal is likely to add to the claims included in the loan loss reserve estimate. However, the extent to which mark-to-market will increase losses above those included in the loan loss reserve estimate is difficult to forecast for

several reasons. First, HUD's current estimates of claims costs associated with mark-to-market are preliminary and, in our view, subject to considerable error. Second, because some loans that are covered by mark-to-market are also assumed to default in the loan loss reserve estimate, total expected losses cannot be computed by simply adding mark-to-market costs to loan loss reserve amounts. Third, the loan loss reserve amount is conservative and is based on a higher level of defaults than HUD has experienced historically. Loans for programs that are not impacted by mark-to-market may not default at the rate assumed in HUD's loan loss reserves, thereby potentially providing a buffer for the increased defaults on loans that are marked-to-market. After HUD's cost estimates are refined to incorporate better data, the Department and others will be in a better position to assess the adequacy of FHA's multifamily loan loss reserves.

Q.3. ***HUD Cost Estimates***—In your statement, you note that the HUD cost estimates are still preliminary and continue to be revised. Further, you note that some essential information is not available; information that will affect costs. Does this mean that we are still unsure what the potential costs of "mark-to-market" will be? How important is this information in analyzing the potential impact to residents and communities? What could be done to improve the accuracy of these estimates?

A.3. HUD currently does not have reliable data on a number of the key elements needed to (1) estimate the likely outcomes of mark-to-market at the individual project level, including the likelihood of loan default, (2) determine the amount of the debt write down, and (3) estimate budgetary costs and savings. These include data on the rents that properties can command after they are marked-to-market, information on the physical condition and rehabilitation needs of the insured properties, and information on the potential tax consequences of mark-to-market. As such, HUD's mark-to-market cost estimates are subject to a high level of uncertainty.

Without reliable data, HUD cannot accurately project the likely effect of mark-to-market on residents and communities. HUD has built resident protections into its proposal, such as providing all current residents with portable tenant-based assistance, but the Department cannot yet reliably estimate how many residents are likely to be dislocated or how many properties HUD would recommend for closure.

HUD is currently taking steps to collect additional data. Specifically, the Department has contracted with E&Y Kenneth Leventhal to examine a national sample of 500 assisted properties to enable the Department to better estimate the impact of marking to market at the individual project level. The initiation of this effort has been delayed somewhat; however, HUD still hopes to have the new information collected by September 1995. At the present time it is uncertain to what extent this information will improve HUD's ability to accurately estimate mark-to-market costs and evaluate the implications of alternative policy options.

Q.4. ***Budgetary Costs***—It is my understanding that HUD's estimates on the potential budgetary costs of its proposal have changed several times. What caused these changes?

A.4. HUD's estimates of the budgetary costs of the mark-to-market proposal have been revised several times. These changes appear to be primarily related to the fact that HUD has done additional analyses of the costs of mark-to-market—a process that is still continuing. As noted in our response to the previous question, HUD is currently in the process of obtaining more up-to-date information on properties that would be affected by mark-to-market, including estimates of (1) how many properties and units will be affected by mark-to-market, (2) what market rents the properties could sustain without project-based subsidies, (3) what costs will be involved in rehabilitating the properties, and (4) what amount of mortgage restructuring will be needed. After this information is obtained, it is expected that HUD will make further revisions to its estimates of the budgetary impact of mark-to-market.

Q.5. ***Operating Framework***—If HUD were to go to a "proactive" mortgage resolution strategy, i.e., using joint ventures, what issues should be addressed designing and implementing such a strategy?

A.5. There are a number of issues relating to the proposed use of a joint venture process. For example, a number of important questions relate to how funds received from the resolution of properties would be allocated between HUD and the joint venture partners. According to HUD's 5/26/95 mark-to-market "Operating Framework," HUD would transfer to joint venture entities all or a portion of insurance in force on mortgages included in mark-to-market and the joint ventures would undertake a proactive resolution process. At the time of transfer, HUD and OMB would estimate the cost of resolving the insurance if retained by the Government—otherwise known as "base value." Joint venture entities would be permitted to proactively resolve individual mortgages, so long as the total portfolio recovery exceeds the base value. According to HUD, the entities would bear the downside risk in the event that they cannot recover the base value. Under such an approach, the establishment of base value is important since the Government would apparently share with the joint venture partner(s) recoveries above the base. The Operating Framework does not discuss how the base value will be determined; however, a July 3 memorandum from HUD's Deputy Assistant Secretary for Multifamily Programs states that "we have forecasted the claims that MTM would involve and an MIF joint venture would have to do at least no worse than that." Given the uncertainty associated with the mark-to-market cost estimates HUD has completed thus far, we would have concerns about such estimates being used as a base value. Furthermore, it is unclear whether the HUD/OMB-established base value would be a given or whether it would be a guideline with the actual base value established via a bidding process among prospective joint venture partners.

Other questions relating to the possible use of a joint venture arrangement include: How would joint venture partners be selected and what qualifications must they meet? Who will be the general partner—the Government or the joint venture partner—and what will be the partners' relative equity positions? To what extent will the equity partnerships be leveraged? What policy objectives will the equity partners be required to achieve and how will these re-

quirements be established and enforced? Who will be responsible for determining that the equity partnerships are working effectively and achieving their objectives?

Q.6. ***Short-Term Legislative Changes***—The Subcommittee is concerned about making legislative changes regarding "mark-to-market" due to the lack of information on its potential costs and social policy implications. However, the Subcommittee is also concerned that delays in legislative actions may cause unintended harms to the HUD inventory. What potential problems may occur over the next several weeks or months if no legislative action is taken? What kind of short-term legislative changes could policymakers consider that will mitigate any harm to the HUD inventory?

A.6. As we noted in our statement, the major concern if no action is taken relates to potential disinvestment in the properties. If property owners believe that project-based subsidies are likely to be discontinued, there is concern that at least some owners will make few, if any, additional investments in the properties. This could lead to worsening property conditions and lower property values. It is also feared that the uncertainty regarding the continuance of project-based assistance will make financing more difficult for owners to obtain even if they do wish to make improvements in their properties.

Some of the short-term legislative changes that could be considered as a way to mitigate harm are ones that would increase HUD's ability to take corrective actions if owners fail to comply with housing quality standards or otherwise violate regulatory agreements. Possible actions include revising property disposition laws to loosen restrictions on HUD's ability to use tenant-based assistance in lieu of project-based assistance; allowing HUD to recapture Section 8 project-based assistance when housing assistance payment contracts are terminated because of the properties' failure to meet housing quality standards (so that the funds can be used to relocate tenants if necessary); strengthening HUD's enforcement capabilities along the lines suggested in HUD's American Community Partnerships Act Proposal; and giving HUD greater flexibility in selling multifamily mortgages under such conditions as the Secretary of Housing and Urban Development may designate. Ultimately, however, more fundamental changes will be needed to fully address the problems that currently affect HUD's multifamily inventory—particularly in light of the current budget climate and HUD's limited capacity to manage its multifamily portfolio.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM NICOLAS P. RETSINAS

Q.1.a. ***HUD Cost Estimates***—Are the GAO and IG wrong to be concerned about these data limitations?

A.1.a. The Office of Housing is equally concerned about data limitations and has been and is working to correct problems with the system. HUD has extensive data on the properties in its portfolio. This data has been collected in systems designed around specific functions such as management reviews, physical inspections, annual audited financial statements, and housing assistance payment

contracts. Utilizing updated computer software technology, HUD placed the data from various systems into an electronic data warehouse. Access to the data warehouse now makes it possible for us to refine and use project data efficiently.

We have worked with GAO and OIG on these efforts and their concerns and observations have contributed significantly to our program.

Q.1.b. How significant is the margin for error and has HUD considered the worst case outcomes that may occur under "mark-to-market"?

A.1.b. In developing our current economic model, we attempted to generate very conservative estimates—not a "rosy" scenario, but a scenario that anticipates the highest numbers. Further refinements in our data will reflect lower unit counts due to adjustments for partially assisted properties, exclusion of properties which are assisted by older subsidy programs and exclusion of properties on which a claim has been paid by FHA. Since the same unit total has been used for each scenario in the mark-to-market economic model—maintaining the status quo, mark-to-market, and unmanaged termination of subsidies—revising the number of units downward will merely lower the overall costs for each option without changing the relative costs. Mark-to-market will still be cheaper than the status quo.

The Department is continuing to refine its mark-to-market economic model to increase its predictability. We have contracted with Ernst & Young—Kenneth Leventhal Real Estate Group (E&Y) to conduct a statistically valid survey and analysis of mark-to-market projects nationwide. A sample size of 500 properties has been selected to provide a 90 percent confidence level for the analyses.

In considering the possible outcomes under mark-to-market, it is also important within the larger context. Congress and the Administration have made it clear that the status quo with regard to Section 8 project-based assistance cannot continue. In such an environment, the Department believes that the WORST outcome possible—for tenants, Section 8 owners, the housing stock, neighborhoods, and the taxpayer—would result from having no orderly mark-to-market transition program.

Q.2.a. ***Project Rent Data***—How many properties have contract rents that exceed the comparable market rents or that exceed the rent level necessary to meet project expenses?

A.2.a. Based upon a 1993 analysis of data from a study of the FHA-insured stock undertaken in 1990 by Abt Associates under a contract with the Office of Policy Development and Research (PDR), PDR determined that about three-quarters of all properties have assisted rents in excess of the unassisted rents they could likely command in their markets. More precise estimates of projects in this category will be developed by the E&Y survey and HUD analyses discussed above.

Although the Department does not have specific data on the number of properties with rents exceeding levels necessary to meet project expenses, this could occur in any or all of the properties that receive periodic rent increases based on the Annual Adjustment Factor (AAF).

Rent increases based on AAF's are unrelated to the actual operating costs of the property. Individual properties benefiting from the AAF method have been identified with nearly $2 million in accrued surplus cash (residual receipts). These properties continue to receive contract rents that are significantly above market rents and continue to accrue surplus cash.

Q.2.b. Does HUD plan to reduce contract rents before contracts expire in FHA-insured properties where contract rents exceed market rents? Will HUD consider doing this for uninsured properties?

A.2.b. The Department has requested repeal of Section 142(d) of the Housing Act of 1987, under the proposed American Community Partnerships Act, which would enable the Department to assure that subsidized rents would not exceed the costs of market rents in the area of the subsidized project. Under Section 142(d), rents cannot be reduced, but rather annual rent increases can be limited in order to reduce over subsidization of projects. Repeal of this provision would permit the Department to reduce contract rents to bring them into line with the actual operating expenses, maintenance costs and debt service requirements of the project. Given the budget crisis facing the Department, this represents a realistic approach to maintaining the physical and financial stability of properties with contracts running well into the next century, while helping to restrain subsidy costs.

Q.3.a. ***Properties Included in Mark-to-Market***—Why should we "mark-to-market" these properties if subsidy costs are going to be higher?

A.3.a. It is true that some properties have contract rents that are below market rents. However, these are properties that must have increased revenue if they are to be improved and maintained as safe and decent affordable housing. In those instances, properties will benefit from increased rental income—repairs and improvements needed to make the property marketable can be completed. These increases will be balanced by savings as above market subsidies are reduced. As indicated above, based upon an analysis of data from the 1990 Abt Associates study, the Office of Policy Development and Research (PDR) determined that about three-quarters of all properties have assisted rents in excess of the unassisted rents they could likely command in their markets.

Q.3.b. On what sources of data do you base these judgments?

A.3.b. There are a number of sources. The Department has significantly improved its information on the physical and financial condition of its assisted and insured inventory through private contractors, the experience of our Special Workouts Assistance Team (SWAT) and the 1990 Abt Associates study referenced above.

In an ongoing effort to continuously update its information, HUD is further refining its economic model by securing data on market rents and repair needs through the Ernst & Young (E&Y) contract noted above. E&Y is conducting a statistically valid survey and analysis of a sample of mark-to-market projects nationwide. This survey will provide HUD with projected market rents, operating costs, repair needs, and net operating incomes on 500 mark-to-market projects located across the country. In addition, E&Y's analysis

will enable HUD to develop a cashflow model for predicting the behavior of the portfolio once existing subsidy contracts expire.

Q.4.a. ***Preservation***—Please outline the HUD preservation proposal and how it differs from the "capital grant" proposal in programmatic and budgetary terms.

A.4.a. Our preferred approach is to allow owners to prepay the mortgage and to provide residents with vouchers. Given limited funds, we feel that this is a sufficient response. However, if Congress can identify additional resources, we support a capital grants approach with the following modifications:

- Capital grants available for owners who sell to resident-controlled entities, or to nonprofit organizations or State or local governments with a strong resident component.
- Minimum equity threshold for owners to qualify would be $7,500 per unit.

This is a more targeted, less costly approach than other proposals that have been put forward.

Q.4.b. How will properties eligible for preservation be affected by "mark-to-market"?

A.4.b. Under proposals now under consideration which would permit prepayment of mortgages and offer capital grants for nonprofit or governmental purchasers, a preservation-eligible property could go one of three routes: Prepayment of the mortgage, in which case the property would no longer be included in the mark-to-market universe; transfer of ownership to a qualified purchaser with a capital grant, in which case the property should be able to transition to market when subsidy contracts expire without debt restructuring; or no action under Preservation, in which case the property would be a candidate for restructuring under mark-to-market if it had Section 8 project-based assistance.

Q.5. ***Default Prevention Tools***—What has HUD done to become more proactive in enforcing its requirements?

A.5. HUD has significantly improved consistency in the application of the enforcement remedies available under the terms of the Regulatory Agreement and the Section 8 project-based Housing Assistance Payments (HAP) Contract between the project owners and the Secretary. In addition to the termination of Section 8 assistance payments, HUD has successfully pursued technical (nonmonetary) defaults and foreclosure under the Regulatory Agreement. HUD's success in enforcing the terms of its contracts in those instances where negotiations were no longer an option has resulted in numerous instances of renewed owner cooperation to address critical issues related to their projects. Also:

- Through an Annual Financial Statement Contract, HUD is now receiving approximately 98 percent of the Statements due to it under the Regulatory Agreement, up from approximately 60 percent 5 years ago.
- A Special Workouts Assistance Team (SWAT) comprised of experienced Asset Managers from HUD field offices has been addressing management, physical, financial, and resident issues at selected projects through direct assistance to field office staff.

SWAT members enlist the support and involvement of local government agencies, community organizations, owners, management agents, and residents in addressing the needs of the property. In addition, SWAT members pursue aggressive enforcement of regulations and contracts to secure compliance with HUD's requirements.

- HUD has issued new guidance and conducted training for field offices on loss mitigation tools and techniques.
- A Mortgagee Letter has been issued reminding them of their responsibilities to determine the physical condition of the properties.
- HUD's Office of General Counsel has provided leadership in a number of enforcement actions including those taken against Holiday Lake, Rigsby Apartments, Skytower Apartments, Sierra Nevada Apartments, and Clifton Terrace.
- HUD's OIG has effectively pursued civil actions through the Department of Justice for unauthorized distributions of project assets (double damages).
- HUD has taken direct control of 67 properties representing 9,736 units by becoming Mortgagee-in-Possession.
- HUD has abated or terminated the contracts for Section 8 assistance for 4,050 units in 95 properties based on the owner's failure to maintain the units in decent, safe, and sanitary condition.

Q.6.a. ***Early Termination of Section 3 Contracts***—Under what circumstances would an owner accept early termination of their Section 8 contract?

A.6.a. Owners might be interested in negotiating early contract termination for a variety of reasons. A significant number of Section 8 property owners can be expected to default on their FHA-insured mortgages when their contracts expire and are not renewed. Early termination of Section 8 contracts would be attractive to these owners in particular because the Department's proposal would couple voluntary termination with a proactive effort to restructure the property's financing prior to default. HUD prefers such a proactive approach for mark-to-market because it would make it much easier for good owners to remain in place—and would protect against property disinvestment as the Section 8 program unwinds.

As contracts near their expiration, owners could begin to transition to a market-based relationship with residents—owners would improve the marketability of the property at the same time that residents receive Vouchers or Certificates that provide them with more choice in the selection of housing. In addition, some owners may wish to be relieved of the administrative burden of managing Section 8 subsidies—they would prefer renting to households with Vouchers or Certificates, who have been processed by the Public Housing Agency.

Q.6.b. What would the impact of early termination have on residents and communities?

A.6.b. HUD would agree to early termination of contracts only where the impact on communities, residents, and the real estate would not be adverse and where it was consistent with the housing policies of the Department.

HUD is continuing to analyze the implications of voluntary terminations of Section 8 Contracts. HUD will not consider any contract terminations that do not balance the interests of residents, communities, owners, and HUD.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM LARRY H. DALE

Q.1. ***Impact of Delays***—HUD has stated that "mark-to-market" must be implemented as soon as possible because delays will result in increased costs to the taxpayers and the further deterioration in the neighborhoods where the properties are located. Further, among other concerns, HUD has stated that owners would disinvest in their properties if Congressional action is delayed. What is your reaction to these statements?

A.1. Certain marginal 236 and 221(d)(3) projects that could be assisted by "mark-to-market" will continue to deteriorate. Generally it is cost effective to deal with physically or socially deteriorating low-income housing sooner rather than later. It is not clear to me that "mark-to-market" is the only way to prevent further deterioration. If it becomes clear to owners that the Federal Government has no interest in the continued viability of the low-income housing they own, one should expect that they will act in a way to extricate themselves from the investment at the lowest possible cost to them.

Q.2. ***Project-Based Assistance***—The HUD proposal would convert all project-based assistance to tenant-based assistance. Should this be done for all the properties in the portfolio? If not, under what circumstances will project-based assistance be more effective than tenant-based assistance?

A.2. Project based assistance is particularly attractive when the housing itself is accompanied by special features that make it a particularly appealing living environment for those being served. Special needs housing is the most obvious example but certain elderly housing and housing for the homeless where appropriate support services are offered as a part of or proximate to the housing might also be reason to sustain project-based assistance. In addition, projects located in certain inner-city communities where the project(s) and the support services that are a part of the community (a community which may otherwise be lacking such services) are critical to community viability; could be candidates for continued project based assistance.

Q.3. ***Alternative Proposals***—There have been numerous reservations expressed about the HUD proposal. What other ideas in structuring "mark-to-market" or alternative proposals should be considered by this Subcommittee?

A.3. It would seem that alternative ways to deal with deteriorating 221(d)(3) and 236 projects should be evaluated.

Q.4. ***Mortgage Sales Bids***—As described in the operating framework, HUD would award the bid for a defaulted mortgage based on the highest bid under the "reflector" sales approach. Further, under its joint ventures approach, the framework indicated that maximizing return is its primary objective. Should other factors, besides

maximizing return, be considered by HUD in its design of these approaches?

A.4. It is in HUD's long term interest to retain good quality owner operators of low-income housing. If HUD provides appropriate financing for the restructured ("mark-to-market) project, it will optimize its long-term returns. Tax consequences to owners cannot be ignored.

Q.5. ***Early Termination***—Under the HUD plan, it states that Section 8 contracts would not be renewed when they expire. However, the plan also indicates that contracts would be terminated early if voluntarily agreed upon by owners. Under what circumstances do you think an owner would accept early termination of their Section 8 contract? What would the impact of early termination have on residents and communities?

A.5. Owners would accept early termination when the perceive it to be in their interests to do so—in most cases where the property has a higher value when it is not operated as Section 8 assisted housing.

Assuming tenants were given vouchers, they would be displaced and in many instances relocated into less desirable housing.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM DAVID A. SMITH

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07/30/95

SECTION 8 MARK-TO-MARKET
HEARING JUNE 15, 1995

RESPONSES TO QUESTIONS FROM CHAIRMAN CONNIE MACK

DAVID A. SMITH, RECAPITALIZATION ADVISORS, INC.
JULY 30, 1995

QUESTION 1: USE OF FHA INSURANCE FOR MORTGAGE SALES

The HUD proposal, as we see it today, would not provide FHA insurance.

1.1 What impact would insurance have on those loans sold under HUD's mark-to-market proposal?

FHA mortgage insurance will initially reduce the cost of marking to market (because it will lead to higher recoveries) but will expose the Federal government to continuing financial risk and vulnerability to economic pressure to increase subsidy obligations.

A. The government will initially recover more. Mortgages with FHA insurance are worth considerably more in the marketplace, because the lender no longer has to evaluate the real estate, only the quality of the Federal government's credit. Insured mortgages are also a standard instrument, which makes them easily securitizable, in larger volumes and at higher prices.

Providing FHA mortgage insurance will thus increase Federal recoveries from reconstituted mortgages. Depending on the reconstitution mechanism proposed, the increase in recovery could be substantial

At the same time, providing FHA mortgage insurance requires an allocation of Federal credit subsidy There may be credit-subsidy limitations which would impact HUD's ability to use mortgage insurance in reconstituted mortgages If Congress concludes that FHA insurance is desirable, if not generally then for some portfolio, these issues will have to be researched, and the credit subsidy authorized

B. FHA mortgage insurance creates continuing financial exposure and hidden subsidy-extension risk Traditional FHA insurance is full mortgage insurance (see Section 1 E below), as a result, when an FHA-insured mortgage experiences difficulty, HUD frequently faces the prospect of a large assignment claim (and corresponding mortgage writedown) as compared with a small incremental expenditure to keep the loan out of default

This financial pressure explains why the Section 221(d)(3) and Section 236 portfolio, originally developed with little or no Section 8[1], now has more than 65% Section 8 LMSA When these properties encountered difficulties in the mid-Seventies, it was usually much cheaper to add some LMSA to keep a property out of default -- but (as discussed in Section 6 1(D)) the LMSA continued even though for many properties it was no longer necessary to support the property.

This financial pressure, coupled with natural bureaucratic caution, also explains HUD's historical reluctance to take strong enforcement actions against properties that, although physically decrepit, were paying their debt service -- the net cost of an FHA insurance claim was so high, in financial and administrative terms, that HUD field staff understandably sought other solutions

Both elements of continuing financial pressure -- short-term economics and administrative response -- are endemic to any mortgage insurance system By contrast, an essential premise of mark-to-market is the severance of continuing obligations, whether legal or economic Accordingly, use of traditional FHA mortgage insurance on reconstituted mortgages is generally incompatible with mark-to-market

C. FHA mortgage insurance is not necessary to preserve continuing affordability Even though FHA mortgage insurance has traditionally been used as the vehicle to secure ongoing affordability, it is *not* necessary to preserve affordability after marking to market Owner affordability commitments can be tied to specific subsidy contracts, or expressed in Use Agreements[2], Disposition Agreements, or other documents that are recorded as liens against the property deed Hence FHA mortgage insurance is *not* necessary to preserve affordability after marking to market[3]

D. Although FHA insurance may be generally incompatible with mark-to-market reconstitution principles, Congress should probably give HUD authority to employ it on some specific pools of property. Some pools of mortgages secured by unusual properties may

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[1]Section 221(d)(3) Below Market Interest Rate (BMIR) properties generally had no deep income subsidy, but the Section 221(d)(3) Market Rate/Rent Supplement properties were generally 100% assisted with rent supplement under Section 101 (later phased out and replaced with Section 8) The Section 236 portfolio was largely unsubsidized, except for properties which reserved a portion of their apartments (usually no more than 25%) for very low income residents assisted by Rental Assistance Payments (RAP), another analog of rent supplement also later converted to Section 8

[2]Flexible Subsidy Use Agreements survive prepayment of their underlying FHA mortgages and termination of the HUD regulatory agreement They are valid and enforceable

[3]The Low Income Housing Tax Credit (LIHTC) is a good example of ongoing property-based affordability that exists with no FHA mortgage insurance See Section 4 2(H) below

have little value if uninsured, in such cases, FHA mortgage insurance may be cost-effective Thus HUD should probably have limited authority to apply mortgage insurance in situations where rigorous financial analysis indicates a strongly favorable payback for doing so

Typically these situations arise when there are few comparables for the particular property, which makes the marketplace leery of buying loans on such properties Among the property groups where continued FHA mortgage insurance may be cost-effective are

- Properties with unusual physical configurations (mixed-use, scattered-site rehabs)
- Properties in tertiary (usually rural) markets distant from major cities
- Properties in inner-city neighborhoods where redlining may have taken place

E. If FHA insurance is to be used, Congress should consider reforming the *structure* *of the FHA insurance so as to reduce the Federal government's ongoing exposure.* Mortgage insurance can be structured in either of two ways:

- *Mortgage insurance* If a mortgage-insured mortgage defaults, the guarantor is obligated to buy the loan at par (or, in FHA properties, at 99% of par) The lender's remedy is to exit the loan. Debt service itself is not supported.
- *Payment insurance.* If a payment-insured mortgage defaults, the guarantor is obligated to step in and pay the defaulted debt service; the lender's flow of debt service is not interrupted and the loan does not accelerate Most bond guarantees are effectively payment insurance rather than mortgage insurance.

From a theoretical perspective, payment insurance is clearly superior to mortgage insurance for the guarantor (that is, for HUD), because.

- It obligates the guarantor only to make up the shortfall, whereas in mortgage insurance the guarantor is providing a certain amount of interest-rate hedge
- In a payment-insurance scheme, the guarantor's exposure occurs incrementally, whereas in mortgage insurance, the guarantor must pay the entire principal amount all at once
- If a mortgage-insurance guarantor decides to support a property for a short while, the deferral does not materially reduce the guarantor's risk -- the guarantor is still liable for the full guarantee amount A payment-insurance guarantor who supports a property is ratably reducing its exposure

Unfortunately, despite these theoretical disadvantages, FHA insurance has always been constructed as *mortgage* insurance rather than *payment* insurance But loans reconstituted after marking to market need not be limited to the traditional insurance form, and could employ payment insurance instead

In addition to payment insurance, Congress should also consider risk-sharing approaches, whereby the Federal government insures only a portion of the total loan. Insuring the bottom percentage would be analogous to previous experiments such as coinsurance and state HFA risk-

sharing, insuring only the top percentage would be riskier but would have a stop-loss feature in that only a portion of the loan would be insured

1.2 What other tools would you recommend for HUD?

HUD needs the broadest possible array of restructuring tools, including:

A. *Ability to delegate restructuring or enforcement responsibility to results-oriented private or public joint venture partners including:*
   i. *The Mortgage-Insurance-in-Force joint venture (MIF-JV).*
   ii. *Gatekeepers to determine access to mark-to-market restructuring.*
   iii. *Post-recapitalization compliance monitoring and property inspections.*
B. *A mark-to-market resolution fund from which HUD (or its contractor) can structure one-time capital investments for:*
   i. *Rehabilitation*
   ii. *Individual property operating sinking funds (for good properties in bad locations).*
   iii. *Capitalized debt service subsidy funds to avoid assignment.*
   iv. *Mortgage principal buydowns to reduce debt service and avoid assignment.*
C. *Greatly enhanced and improved Partial Payment of Claim procedures.*
D. *Recapture reuse provisions allowing HUD to reinvest its savings in other activities.*
E. *Alternative restructuring approaches described in Section 5.1 below.*

The FHA multifamily portfolio is diverse, not only in property type and subsidy configuration, but also in markets, owners, investors, and community responses The broader the array of individual property workout tools available to HUD, the better will be its likely recovery Among those we recommend include.

A. Ability to delegate restructuring or enforcement responsibility to results-oriented private or public joint venture partners. HUD has repeatedly stated that it lacks organizational capacity to handle the huge volume of individual property loan restructurings that will be required in marking to market No one is proposing expanding HUD's capacity, therefore, given these limitations, HUD must be given authority to delegate its restructuring or enforcement responsibility to appropriate partners Among the possible delegations are

i. The Mortgage-Insurance-in-Force joint venture (MIF-JV). HUD has already proposed using joint venture investor partners, in a manner analogous to the RTC partnerships, to resolve loans These joint ventures are an important element, provided that the MIF-JV partner is given financial incentives corresponding to the public-policy objectives outlined in Section 6.1 below

ii. Gatekeepers to determine access to mark-to-market restructuring
As discussed in Section 4 below, we believe that in many (if not most) cases, property-based assistance (and continuation of regulation for below-market properties) will produce a better financial and policy result for the Federal government At the same time, within the existing portfolio are both fatally flawed properties and incorrigible owners or managers, HUD will need to hire 'gatekeeper' entities to screen out both situations before renewing contracts or continuing property-based regulation

iii. Post-recapitalization compliance monitoring and property inspections. To the extent that property-based assistance is a continuing element in the HUD multifamily portfolio, these properties will require periodic compliance monitoring and physical inspections. If HUD remains incapable of performing these functions, they will have to be either devolved to state and local agencies or privatized (along the lines described in Section 4 2(H) below)

B. A mark-to-market resolution fund from which HUD (or its contractor) can structure one-time capital investments. To minimize its net costs from marking to market, as well as to maximize the ongoing affordability and property quality, HUD should have access to a mark-to-market resolution fund to capitalize individual properties in the following situations

i. Rehabilitation HUD will achieve a better result if it invests in renovating some properties before exposing them to mark-to-market recapitalization and their loans to mark-to-market reconstitution and sale For this purpose, a capital fund is necessary, we understand HUD has proposed having $3 billion available.

ii. Individual property operating sinking funds (for good properties in bad locations). After their rents are marked down to true market, some good properties in marginal locations can initially pay *no* debt service or even have negative Net Operating Income For a few years after conversion, their earning power may be depressed (as they renovate or add amenities). If the property's economic recovery (at least to positive NOI) is relatively predictable over a short to intermediate term (roughly three to eight years), HUD could set up a property operational sinking fund, capitalized at the time of marking to market, which would (together with the interest earned thereon) be enough to cover the projected operating deficits This would give the property a chance to survive while at the same time quantifying and limiting the Federal exposure

iii. Capitalized debt service subsidy funds to avoid assignment. After marking rents to market, some properties will generate *almost* enough money to fund their full debt service Assignment destroys value, not only in transaction fees and costs but also because a mortgage reconstituted at market interest rates has a recovery less than the principal required to pay off the current below-market mortgage If the net discounted cost of keeping the property out of default is less than the interest arbitrage loss from assignment-reconstitution, the Federal government will achieve a superior result by providing an annual debt service subsidy to cover the difference (Mechanisms can also be built into this approach to minimize the actual draw on the debt service subsidy fund, and to motivate the owner)

iv. Mortgage principal buydowns to reduce debt service and avoid assignment. As an alternative to the capitalized debt service subsidy, HUD could make a one-time advance principal payment to buy down the mortgage *while it was current* Assuming that the loan term remained unchanged, this would compel the mortgagee to recompute new lower debt service; the buydown would be at the minimum level needed to reduce debt service to the level the property could support

C. Greatly enhanced and improved Partial Payment of Claim procedures. HUD should develop a more aggressive Partial Payment of Claim (PPC) procedure for use when the property's default is inevitable but lies in the future As with current Partial Payment of Claim procedures, the mortgagee would not assign the entire loan, instead the mortgagee would assign the non-performing portion only. This would prevent HUD from taking a net loss on the negative interest arbitrage that occurs when a low-interest loan is recapitalized at market rates

Some care needs to be taken in this Partial Payment of Claim approach, however, to avoid compromising the mortgagee's contractual rights, and also to assure that the Partial Payment of Claim procedure is not scored as costing HUD new credit subsidy allocations for the unassigned principal portion.

Further, HUD needs to create leverage to negotiate proactively with mortgagees, such as could be obtained by two ideas listed in the previous subheading. An annual debt service subsidy (Option B.3 above) would prevent *any* assignment, a less attractive result for the current holder of a below-market loan than a Partial Payment of Claim on the terms outlined above. A capitalized fund that could make advance prepayments of principal could also compel the mortgagee to recast the remaining mortgage and reduce the mandatory debt service (in effect, a pre-emptive strike on Partial Payment of Claim) Having both such capabilities already in hand would motivate mortgagees to negotiate reasonable Partial Payment of Claims

This example also demonstrates the importance of HUD having multiple restructuring options available to it, as well as capable restructurers as its joint venture partners, since other parties will judge the strength of HUD's negotiating position by the range of options available to it and its willingness to use them

D. Recapture reuse provisions allowing HUD to reinvest its savings in other activities. Mark-to-market is intended to reduce ongoing Federal discretionary outlays with the minimum level of capital costs required In effect, HUD as an agency would be put in an entrepreneurial position To motivate HUD, and to create the working capital needed for a resolution fund (such as described in Option 2 above), HUD should have the benefit of the 'recapture/reuse' provisions so that HUD could reinvest recoveries from mark-to-market loan reconstitutions and other cost savings into further mark-to-market initiatives

QUESTION 2: CONCERNS OF OWNERS

In your statement, you mention that HUD's operating framework puts owners at high risk of foreclosure.

2.1 Please explain in more detail why owners are at high risk of foreclosure.

Owners whose properties will undergo large debt writedowns are at high risk of foreclosure because:

- *Owners will be disadvantaged in pooled auctions.*
- *The winners of unstructured auctions will sometimes be entities economically motivated to foreclose (and so capture ownership benefits) rather than to restructure the loan.*
- *If that occurs, owners will have much less negotiating leverage than they do in more common conventional loan default workouts.*

The owners' high risk of foreclosure is a consequence of a sequence of factors

A. For many properties, default will be inescapable and survival will be wholly dependent on restructuring the mortgages Unlike other workouts, where the owner may be only a short distance below breakeven, these mark-to-market properties will face *enormous* reductions in their ability to pay debt service. For instance, the typical New Construction/ Substantial Rehab property will have less than half as much Net Operating Income (NOI) after marking-to-market as it will need to pay its mortgage.

Monetary default will be inescapable Moreover, incremental solutions by the owner will be insufficient to cover the vast gap. Thus the owner's continued survival will depend wholly on its ability to negotiate a workout with the ultimate loan buyer.

B. Unstructured auctions encourage owner disinvestment before default. Whereas structured auctions encourage owner reinvestment before default, unstructured auctions, especially those with long lead times between establishment of policy and implementation of the auction, do encourage disinvestment.

In an unstructured auction scenario, the typical mark-to-market property can *never* achieve breakeven (at original debt service) on its own and instead depends wholly on the workout, so any improvements the owner might make to the property before default will be essentially *irrelevant* to the owner's chances of survival. Further, in an unstructured auction the owner may have a better economic negotiating position against a new lender if it *depresses* the property's value before default (or hoards cash in the property), because these actions (1) accumulate working capital (for obstructive actions, see Section 2 1(C) below), and (2) lower buyer expectations about the property's future cash flow potential (and hence their negotiating leverage)

This economic incentive to disinvest is present only in *unstructured auctions when the property's operations are far below required debt service* Disinvestment is far less of a risk in default-avoiding resolution mechanisms, structured auctions, formula restructurings (if properly designed), and voluntary pre-expiration negotiations See Section 5 1 below

C. *Unstructured auctions will attract two types of bidders: lender securitizers and forecloser acquirers.* In HUD's reflector sale approach, the borrower's underlying loan is not affected by the loan auction the bidder who buys, even a substantial discount, will inure to the full original loan at face (If for example the loan had an unpaid principal balance of $1,000,000 and the high bidder offered $400,000, the borrower would still owe $1,000,000.) These auctions will attract two different types of bidders.

- *Lender securitizers* who have no interest in foreclosing, but who simply want the loan reconstituted onto performing status as quickly as possible so that they can bundle it with other loans, securitize it, and make a spread profit.
- *Forecloser acquirers* who see the loan as a vehicle to capture ownership and its attendant benefits. In addition to the same level of securitizable cash flow which lender/securitizers perceive, forecloser/acquirers may be interested in
  - *Control* over contracts for property management and affiliated services
  - *Tax-avoidance payment leverage over limited partners* who face potential large Federal income taxes upon foreclosure (or cancellation of indebtedness) and who may thus be willing to spend money to buy off a foreclosure risk.
  - *Upside and future residual value* arising from the property's appreciation over time

D. *In unstructured auctions, forecloser/ acquirers will always be able to outbid lender securitizers.* Lender/securitizers will be valuing only one of the four components of value inherent in a mark-to-market mortgage -- the current (or near future) securitizable cash flow. Forecloser/acquirers will be valuing all four components. Even though the current securitizable cash flow is by far the largest and most valuable element, the others are material, with collective value equal to a significant fraction of the cash flow value[4]

Ordinarily, a lender/ securitizer might have a lower cost of capital than a forecloser/ acquirer, but when large numbers of similar properties are to be auctioned simultaneously, the forecloser/ acquirer can simply team up with a lender/ securitizer and so eliminate that competitive disadvantage

In any auction where one class of buyers has a significant advantage over other classes of buyers, the advantaged class will win most if not all of the auctions Here the forecloser/

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[4]Some properties will have zero ability to pay current debt service after marking to market; their securitizable loans will be *zero* In such cases, the *only* bidders will be forecloser/acquirers; all such properties are almost certain to be foreclosed if sold in an unstructured auction.

acquirers will have significant advantages over lender/ securitizers, we thus believe they will win any auction they want to win

E. Once the new bidder has bought the mortgage, the owner's defenses are principally obstructive and negative Once the new lender is in place, the owner can seek to negotiate a workout, but if the lender presses foreclosure, the owner has only a few defenses, all of them obstructive Bankruptcy filings will delay foreclosure a short while[5] and cost the lender legal fees Other litigation is likely to be rapidly dismissed In short, the owner has little to work with

Negotiation works only when both parties have something to lose if no agreement is reached -- in other words, only when a negotiated settlement is significantly better for *each* party than that party's best unilateral alternative (its 'or-else') Here the lender's 'or-else' is scarcely worse than a negotiated solution, and for a forecloser/acquirer, the or-else is actually *superior* to the negotiated settlement

Any owner whose loan is bought by a forecloser/acquirer will be foreclosed

F. Mark-to-market loan restructurings differ fundamentally from the RTC loan resolution mechanisms, where many owners survived. Proponents of mark-to-market argue that the RTC experience should encourage capable owners to believe they will survive the mortgage restructuring. These observers suggest that capital securitization pressure (to make the securitizer's return) will create powerful incentives for lender/securitizers to negotiate rapid reconstitutions of mortgages, so that they can be included in large securitization pools which in turn allow the lender/securitizer to recoup its equity capital and make its high rate of return

Although only peripherally familiar with the RTC auctions, we respectfully suggest that the facts in mark-to-market properties are more strongly tilted in favor of foreclosure than they were in the RTC auctions, as follows

Attribute	RTC	Mark-to-market	Favors
Mortgage discount required	25% or less	60% or more	Foreclosure
Potential cancellation of debt income	Low	High	Foreclosure
Homogeneity of property types	Low	High	Foreclosure
Operational transformation necessary?	No	Yes	Mixed
Program requirements impaired value?	No	Yes	Neutral

[5]Until a few years ago, bankruptcy laws pertaining to single-asset companies (such as real estate partnerships) favored the debtor, to the point where real estate partnership bankruptcies were an inevitable and serious obstacle to lender foreclosure These excesses led to a series of bankruptcy reforms which have substantially narrowed the circumstances under which a single-asset debtor can prevent the secured creditor from gaining prompt relief from the foreclosure stay Similarly, the Section 1129 cramdown provisions, whereby a debtor can force a 'crammed down' reduced mortgage on a secured creditor, have been more narrowly construed The net effect is that bankruptcy is now principally a delay strategy with little hope of preventing the foreclosure, and its use as an obstructing tactic has greatly diminished

In HUD mark-to-market, the high mortgage discounts required and severe risk of cancellation of debt income increase the loan buyer's foreclosure leverage in the mark-to-market context Homogeneity of property type increases the value of foreclosing (because it creates instant operational economies of scale). The necessity for operational transformation (and capital reinvestment) may give a premium to the better current owner/managers (a factor favoring workout) but it will also give pause to typical loan securitizers, discouraging them from bidding aggressively on those assets and making foreclosure/acquirers more likely buyers (a factor favoring foreclosure)

In a typical RTC situation, default was a risk the borrower accepted at inception, and the lender has no complicity in the default -- it occurred because the owner was incompetent or unlucky By contrast, the owner in a mark-to-market property is in no sense culpable -- unless developing a property with a forty-year mortgage and gullibly accepting a twenty-year subsidy commitment is a kind of culpability -- while the government shares complicity in the impending default Federal action intervened in choosing the property, siting it, and insisting on its amenities (or lack thereof). Having deliberately constructed financing programs requiring above-market rents, the Federal government now withdraws those rents and is the proximate cause of the property's default

In a normal conventional property, a lender who intervened as much as HUD in the property's original development and subsequent operations would be considered vulnerable to 'lender liability' litigation from a borrower, who could persuasively argue that the lender should be estopped from foreclosing on the grounds of having interfered with the owner's business and hence sharing complicity for the defaults on the basis of which it now seeks to foreclose. To the best of our knowledge, the lender-liability defense has never been asserted against HUD, a state housing finance agency[6], or any other public-sector lender .. but Congress should satisfy itself that any such lawsuits, if brought, would be promptly dismissed with little expenditure of public resources.

G. *Owners now <u>believe</u> that unstructured auctions place them in jeopardy of foreclosure.* Ever since the release of HUD's Operating Framework, individual owners and owner trade associations have been unanimous, adamant, and vocal that it places them at high risk of foreclosure Although not dispositive, this evidence is material.

2.2 What are your recommendations for addressing these concerns?

Congress should state as a public policy objective its desire to craft a resolution mechanism that allows capable owners to survive during mark-to-market, and should establish performance-based criteria for judging owners' capability. Additionally if loan auctions are to be used to re-size the debt, the auctions should (1) require a writedown in the mandatory debt to

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[6]In the early 1970's, several state HFA's interfered aggressively with the construction and development decisions; one agency went so far as to insist on having its subsidiaries admitted as co-general partners. Unfortunately for owners, lender liability did not exist as a legal defense then, so its applicability was never tested

the price paid by the winning bidder, and (2) allow the owner either a right to match the winning bid or to buy a participation in the top percentage of the winning bid.

A. Congress should adopt policies which keep owners and property managers motivated before, during, and after mark-to-market Affordable housing property management is widely recognized (among both affordable and conventional managers[7]) as a difficult business that is more complicated and more management-intensive than operating conventional property, for the following reasons

- HUD regulations limit the owner/manager's range of responses
- Affordable properties are usually in more difficult locations than conventional
- Affordable housing residents include a higher proportion of families with social needs
- Older assisted properties operate by design on narrow cash flow and working capital margins

Experience has shown that affordable housing properties demand capable management, and that if management falters, even for so short a period as six months, the property's operations may be materially harmed. Once a property becomes troubled, restoring it to health is usually difficult, not only because of limited capital resources, but also because the resident protections contained within existing statutes and regulations give owners and managers few remedies to improve a property's tenancy

Given this practical reality, Congress should adopt policies which provide continuing positive motivation to owners and managers Although the HUD regulatory framework eliminates most of the potential for active property disinvestment (see Section 3 1(B) below), a property's value can be permanently impaired if the owner or manager slacks off for any protracted period Thus a Congress interested in sustaining property value and protecting the residents' quality of life should take steps to make sure that owners and managers remain positively motivated before, during, and after mark-to-market

If (as we recommend) continued affordability is a component in the ultimate mark-to-market resolution, structures that motivate owners after marking to market are essential

B. Incorrigible sponsors and fatally flawed properties must be culled Within the existing affordable portfolio are a small but disproportionately visible number of incorrigible sponsors and fatally flawed properties The conduct of these owners is indefensible, as is the condition of the properties -- yet bitter recent experience has shown that the current configuration of subsidy, regulation, and HUD administration has rendered the Department incapable of

[7]In May, 1994, Recap Advisors delivered a report commissioned by HUD Multifamily entitled "HUD Multifamily Property Management Fee Study " As part of that report, Recap interviewed nearly sixty organizations, including owners, managers (both affordable and conventional), investors, state housing finance agencies, and HUD (both Headquarters and field office staff). As might have been expected, all segments of the affordable housing community -- owners, managers, and regulators, both HUD and state HFA -- generally concur that affordable housing management was more difficult than conventional More surprisingly, however, *half of the conventional owners and managers interviewed also felt that affordable housing management was more difficult* (the other half thought the two jobs equally difficult)

expelling these sponsors and forced to reinvest continuously in hopeless properties The continued presence of these outrageous situations erodes confidence in the entire system and corrupts observers' perspectives on HUD, the portfolio, and indeed affordable housing as a social policy

Politically and in terms of policy, continuation of any system that cannot eliminate these outrages is intolerable Any mark-to-market portfolio resolution strategy *must* cull these sponsors and these properties

HUD's approach sells the entire portfolio wholesale, with no government effort to distinguish the capable from the corrupt and no expression of the importance of affordability Though understandable, this is an over-reaction; instead Congress should construct a system whereby unacceptable owners and managers are identified and culled

Using contractors (such as joint venture partners) may be an effective means of achieving such selection without embroiling the Federal government in continuing controversy, or it may be desirable to identify objective criteria which distinguish suitable owners and managers, including the following:

- The property's physical condition.
- The owner's performance history on this property, including the absence of adverse findings as well as physical inspection reports and management reviews
- The owner's behavior since HUD announced its intention to mark to market. (Willful disinvestment after announcement of mark-to-market should be by itself a sufficient criterion for disqualification.)
- The owner's efforts to keep the property well capitalized and in good physical condition, with a capital investments plan and efforts to increase replacement reserve funding and to build up replacement reserve balances
- Prior history with the property, especially any evidence of monetary advances, fee subordinations, or other activities above and beyond those contractually required
- The owner or manager's historical responses to unexpected problems in the past
- The quality of reporting information, especially historical financial reports
- The volume of resident comments (or complaints), especially on a continuing basis
- Other properties in the owner or manager's portfolio.

C. Assuming that the mark-to-market system will cull unacceptable owners and properties, Congress should establish continuation of good ownership as a desirable policy outcome in marking to market As discussed at length in Section 6 1(E) below, we believe that making the owner community constructive participants in mark-to-market will not only be fair to program participants, it will also help the Federal government achieve a better financial result Given this, Congress should publicly express this belief

As a first step in demonstrating partnership with good owners, Congress should state that it has no intention of creating systems which expose owners or managers to risks other than those over which the owner or manager had control As an appropriate corollary, Congress could also

identify specific behaviors which it intends to use as litmus tests of owner capability, such as those identified above In view of the expressed concern over disinvestment, Congress could craft a cogent short statement to the effect that disinvestment will be regarded as evidence of unsuitability, whereas continued commitment and effort will be regarded as evidence of suitability for continued ownership.

D. Congress should agree upon and publicize a set of specific mark-to-market operational approaches that will motivate owners between now and contract expiration General statements of intention help persuade skeptical participants, but as everyone knows, the devil is always in the details: even more persuasive as a motivational tool to owners will be specific resolution mechanisms that owners can examine for themselves and from which they can take comfort about the future.

Unfortunately, some systems that give comfort to good owners provide a sinecure to bad owners, so from Congress's perspective there will be a tension between expressing a resolution mechanism that inspires confidence and preserving a system that creates powerful motivation from the owner community Among the ideas which may be shaped into suitable proposals are the following

- *Formula debt restructuring* where the owner can have reasonable assurance of escaping immediate foreclosure, but where the owner's ongoing participation in economic benefits[8] shrinks (within reasonable bounds[9]) as HUD's mortgage writedown increases (Such a system also has the desirable side effect of allowing the owner to quantify precisely how much incremental benefit it can gain from reinvesting in the property and adding value to it *before* marking to market.)
- *Delegating portfolio resolution* to an outside partner (such as HUD's MIF-JV) but establishing an incentive compensation system for the joint venture partner that weights the owner's continued participation as a component in the overall evaluation of a transaction By the proportional weights assigned to various components, Congress can explicitly define the relative importance of financial recovery, reduction of ongoing Section 8 outlay commitments, continuation of affordability, capital reinvestment, and enfranchisement of capable owners
- *Competitive auction systems* structured so that capable owners can compete on an equal footing with large capitalized financial sources (discussed at greater length in Section 2 2(D) below)

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[8]Of course HUD has no legal authority to take away ownership in a property, instead HUD could accomplish the same economic objective by recasting the written-down mortgage debt as a note repayable solely from a percentage of ongoing cash flow, with the owner receiving all remaining cash flow The mortgage's cash flow repayment percentage thus would constitute the economic equivalent of an ownership position, without compromising the owner's basic rights Some tax structuring would also be necessary to avoid triggering gain to the owner through dilution of ownership and loss of basis

[9]Any formula that changes the owner's net participation should never decrease the owner's participation in ongoing operations below some floor percentage (such as 25%) designed to keep the owner motivated after marking to market

E. If an auction structure is finally adopted, it should allow the owner to participate in the auction on an equal footing HUD's Operational Framework builds on RTC experience which gives support to the proposition that open auctions of defaulted mortgages are an optimal way for the Federal government to dispose of large blocks of assets with maximum expected recovery

For the reasons discussed below, we question whether open auctions are the most suitable approach for mark-to-market mortgage restructuring, still, if Congress elects that avenue, refinements can diminish the individual owner's bidding handicap Out of the many possibilities, we give below three specific structures which are illuminating and potentially useful

i. Handicaps of the individual owner in an open pooled auction In an open auction, an individual property owner faced significant handicaps against a large institutional buyer. The large buyer has access to less expensive capital, whereas the current owner is an individual partnership whose limited partners are typically scattered throughout the country and who have widely varying financial objectives Limited partnerships are also relatively inflexible, like a lobster shell, they neatly fit the property's original financial configuration but have little ability to expand their capitalization

The very structure of a large pooled auction, with buyers not required to specify individual loan prices, works against the individual buyer because, to compete with a buyer's premium on a pool bid, every single individual owner must make a matching premium bid To counteract this, *any pool bid should require the bidder to allocate its purchase price among individual loans, and each loan should be sold to its individual highest bidder*

ii. An owner's option to match or top the winning bid Similarly, assuming that Congress adopted the individual-bid approach to loan auctions, Congress could extend to the current owner the right to match the winning bid This would allow the current owner to compete on equal footing

Of course, such a right to match would slightly chill the market of buyers, and thus lead to some diminution of value compared with an open individual-property auction that lacked a right to match But we believe that the net discount lost of each individual transaction would be more than counterbalanced by the increased portfolio value resulting from owner willingness to reinvest during the period before marking to market

If it so chose, Congress could counterbalance this potential discount by granting the owner a right to top the winning bid at some modest premium (such as 5%) over the winning bid (Thus if the winning bid for a loan were $2,000,000, the owner could match only if it paid $2,100,000) The right-to-top premium should be set at a level low enough to motivate owners, but high enough to represent reasonable compensation for the concession of allowing the right to top

iii. Restatement of mortgage principal to the face amount of the winning bid The owner's disadvantage in an auction stems largely from the enormous overhang

of remaining mortgage balance due in excess of the winning bid, which leaves the owner at the buyer's mercy. This could be counterbalanced by stating that lenders will be buying a new loan whose principal amount equals the face amount of their winning bid, so that in effect they would be buying loans at par (To prevent the loans from selling at a discount, the interest rate should be pre-set at a market-competitive level for securities of similar age, this could be established as some number of basis points over Treasury bills for comparable long maturities)

Such a structure would not inhibit lender/ securitizers, who would still be able to make their profit spread by packaging pools of loans, credit-enhancing as they chose, and reselling at lower interest rates (hence higher principal), but it would significantly crimp the leverage of forecloser/ acquirers

QUESTION 3: IMPACT OF DELAYS

HUD has stated that mark-to-market must be implemented as soon as possible because delays will result in increased costs to the taxpayers and the further deterioration in the neighborhoods where the properties are located. Among other concerns, HUD has stated that owners would disinvest in their properties if Congressional action is delayed.

3.1 What is your reaction to these statements?

Owner disinvestment became a risk only with the introduction of HUD's operating framework. It will cease being a material risk if capable owners regain confidence that they will be able to survive mark-to-market.

Congress needs to act immediately <u>to establish its public policy objectives</u>, among which should be a recognition of the importance of making the owner an ally of the mark-to-market process. If Congress adopts such a policy objective, owners will reinvest rather than disinvest. Further, formula-based resolution mechanisms can be designed that will reward owners for reinvesting and punish them for disinvesting.

Reducing the risk of disinvestment is an important element in the design of suitable portfolio resolution strategies A clear expression of policy imperatives is the crucial first step in such an approach, however, to date HUD has offered no policy objectives except rapid liquidation and maximum return For the reasons outlined below, such a policy does nothing to encourage owner reinvestment Having in effect shouted fire in a crowded theater, HUD now argues that, because panic is inevitable, Congress too should run for the exits

A. Because lenders cannot disinvest in property, lender activity in the secondary mortgage market will have no impact on properties or residents. Lenders can sell mortgages -- in the secondary mortgage markets, mortgages are bought and sold more or less continuously -- but they cannot disinvest in the *property*, because they have already made their investment, and have no direct influence over property operations Lenders who become

discouraged can sell the loan to a third-party buyer, but this will not change the fundamental contractual relationship between the owner and its (new) mortgagee

Lender (or credit agency) discouragement with HUD policies will affect the prices at which HUD mortgages trade in the secondary market, in turn, this will affect FHA borrowings on *new* properties Paradoxically, lender discouragement thus hurts the new Federal Housing Corporation's ability to fulfill *its* mission but has no effect on the current portfolio.

B. *Because the properties are heavily regulated now, the potential for owner disinvestment is limited* All properties in the mark-to-market universe are regulated by HUD as to their:

- Rents
- Tenants.
- Required reserves
- Operating budgets.
- Uses and distributions of cash flow.
- Changes in ownership and management

All these properties are required to report monthly to HUD

Compared with conventional properties, this is an enormous level of intrusion, regulation, and reporting. Thus the potential for owner disinvestment is greatly limited, both in scope and in time; long before any owner's disinvestment became serious, HUD would know about it and have enforcement mechanisms to stop it

Disinvestment is a theoretical risk much more than an immediate problem

C. *Some marginal or troubled properties are deteriorating today; they should be addressed whether or not mark-to-market is implemented* Within the portfolio are some properties that today are deteriorating, in two basic classes:

- *Troubled* properties are already experiencing financial or operational distress In almost all cases these properties have physical or locational handicaps which have been present ever since they were developed A few became troubled only in recent years with the infusion into urban neighborhoods of crack cocaine In any case, these properties *already* have too little capital to operate

- *Marginal* properties are barely covering their operating costs Many of these properties are atrophying slowly toward financial distress solely because, as they age, their major physical systems (roofs, siding, heating) wear out and the property lacks access to capital for reinvestment These properties are consuming their internal financial resources (working capital, replacement reserves, ability to stretch out trade payables or to defer some maintenance), when a crisis strikes, they will have no protection left and will be vulnerable to rapid disintegration of value

If nothing is done, both classes of properties will suffer, deteriorate, and most likely default. Mark-to-market sends them a mixed message though it offers hope of reducing their required debt service and thus giving the property working capital, it also threatens dispossession of the owner.

As time passes, these properties will become increasingly expensive and difficult to resolve. In this sense, there is an urgency to developing a coherent portfolio resolution strategy, whether it be mark-to-market or portfolio recapitalization.

D. *Owners will disinvest before marking to market only if they think that either (1) they are unlikely to surviving marking to market, or (2) reinvestment before default does not increase their chances of surviving.* Owners will disinvest if they think that doing so gains them more than reinvesting. In a normal context, the owner has equity so reinvestment increases the owner's equity; reinvestment only becomes pointless if the owner has so much negative equity that the incremental reinvestment makes no practical difference in the owner's survival chances.

Disinvestment by the owner is a rational strategy under one condition: *only if* an owner believes it has no equity remaining in the property. Disinvestment is a last resort adopted when dispossession without compensation is a virtual certainty, and there is no meaningful hope left.

The Department's May, 1995 Operating Framework emphasizes unstructured loan auctions. Not only would owners have no protections, they would also be exposed to a new mortgagee whose economic motivations would emphasize foreclosure, after an auction process that would most likely assure that bidders who intend to foreclose would win by paying more than bidders who intend to restructure (as discussed in Section 2.1(D) above).

In a scenario where the owner believes it will not survive the restructuring, there is no incentive for an owner to optimize operations before the loan auction. Indeed, the economic incentive is to under-rent and over-spend, so as to minimize the property's earning power (as discussed in Section 2.1(B) above).

By presenting unstructured auctions as the predominant means of loan restructuring, a method which HUD can unilaterally adopt, HUD inadvertently encouraged owners to disinvest. Subsequently, HUD's presentations have downplayed the unstructured reflector auction and have instead emphasized joint venture resolution and pre-default negotiations[10]. These will decrease the risk of disinvestment *provided that* Congress clarifies its policy objectives (along the lines discussed in our responses to Questions 2.2, 5.1, and 6.1).

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[10]So far, however, HUD has given no indication of the public-policy imperatives which it believes should be included and has pointedly declined to identify the continuation of good owners among them. The prospect of future (unstated) policy imperatives to be decided by HUD at a later date has so far given owners little comfort.

E. Some mark-to-market mechanisms will create disinvestment after marking to market The risk of disinvestment is not confined to the period of policy debate Implementation of mark-to-market will affect owners' reinvestment in two ways

- *Individual properties after marking-to-market* As individual properties go through contract expiration/ renewal, mark-to-market, or recapitalization, their owners (either current or new buyers) will be motivated to invest if they retain economic upside from cash flow and later residual value Preserving or creating economic motivations after recapitalization is thus essential to the future health and viability of the portfolio This is especially crucial if (as we recommend) Congress adopts continued affordability and preservation among its public-policy objectives for mark-to-market

- *Properties whose contracts do not expire for several years* Once mark-to-market is enacted, evidence of the owner's chances will rapidly accumulate If owners with late-expiring contracts see those with early-expiring contracts being systematically foreclosed, disinvestment could become rampant

F. Totally vouchering out the stock increases the likelihood of disinvestment Vouchering out the affordable housing stock, if adopted as a strategy, will lead to disinvestment in several undesirable ways.

1. *Deterioration of good properties in marginal neighborhoods* Within the assisted portfolio today are a meaningful fraction of properties kept in good condition by rents higher than the market. Those rents represent the price of affordability and of providing much needed housing in difficult locations Reducing them to true local market (without some form of viability sinking fund, as described in Section 1 2(B)) will inevitably lead to a deterioration of those buildings down to the level of their surrounding neighborhood

2. *Neighborhood disinvestment resulting from a voucher influx* Flooding markets with Section 8 vouchers could also lead to significant neighborhood disinvestment, not necessarily among the properties HUD currently regulates, but in the surrounding communities.

   Several cities that have experimented with large-scale use of Section 8 vouchers (Boston, Wilkes-Barre, and Raleigh, to name three) have later rejected the experiment In those markets, the presence of large number of voucher holders rapidly called into existence a kind of landlord wholly absent from the property-based inventory, an exploitive landlord who bought property principally for the purpose of filling it with as many voucher holders as possible Some neighborhoods in Boston experienced remarkable disinvestment over a five to ten year period, solely as a consequence of property being transferred to absentee owners who turned properties into vouchers-only apartments[11]

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[11] The Boston experience is chronicled in *A Street of Strangers: A Case Study (60-80 Florida Street, Dorchester)*, submitted to Mayor Raymond L. Flynn by the Mayor's Committee on Subsidized Housing/ Absentee Landlord Issues, August, 1992 Copies of the report are available from Recap Advisors.

G Congress can discourage disinvestment by expressing a clear set of public policy principles to be used in marking to market To eliminate incentives for owners to disinvest, Congress should clarify its public-policy principles As discussed in Section 6 1 below, we believe the appropriate public-policy principles are these

1. Preserve affordability on an ongoing basis
2. Anchor communities by financially capitalizing good properties to be self-sustaining
3. Avoid default (if possible) on mortgages with interest rates below market
4. Wean properties off Section 8 without forfeiting affordability.
5. Avoid disenfranchising good owners who have developed and operated good properties according to HUD's rules

QUESTION 4: USE OF PROJECT-BASED ASSISTANCE

The HUD proposal would convert all project-based assistance to tenant-based assistance.

4.1 Should this be done for all the properties in the portfolio?

No; resident-based assistance is better only when:

- *The voucher cost is cheaper than property-based (generally for properties too expensive to preserve), or*
- *The property or ownership is fatally flawed and the property must be culled from the affordable housing inventory.*

A. Ways to provide housing affordability Housing affordability can be delivered to residents in either of two ways

- At the individual resident level by increasing the resident's rent-buying power (as with Section 8 vouchers or certificates)
- At the property level, either by
  - Buying down the cost of housing (with capital subsidies, such as the original Section 221(d)(3) BMIR or Section 236 programs and the current LIHTC program).
  - Attaching rent-buying subsidies to the property (as with the Section 221(d)(4)/ Section 8 Tandem properties)

Congress has enacted laws using all of the above methods Each has a place in a well designed affordable housing program

B. Benefits of property-based assistance HUD's materials have done a good job of documenting the potential advantages of resident-based assistance, but have glossed over the benefits from property-based affordability, which include the following

1. *Bargain element* Many older assisted properties will remain affordable even without Section 8 subsidy Congress negotiated an affordability bargain twenty years ago and it should not be given away for nothing

2. *Future affordability hedge* Property-based affordability hedges against the future Vouchers work only if Congress continuously appropriates money for them, and then only if the resident can find adequate housing with the voucher payment standard In soft markets, vouchers work well, in tighter markets, voucher holders are often squeezed out Further, as markets tighten, the cost of vouchers rises

   Vouchers are similar to term life insurance -- they are a finite benefit for an annual cost. Property-based assistance is similar to whole life insurance -- the Federal government realizes additional benefits each year it is extended

3. *Greater accountability.* Property-based affordability allows greater accountability in the owner[12] With a voucher, moveout is the resident's principal remedy, and if the resident is reluctant to move (for a variety of personal reasons), the resident is vulnerable to exploitation With actual vouchers now in use, many residents do not use in practice the remedies they have on paper, and HUD has no idea of and little control over the conditions of resident assistance

4. *Economies of scale* Property-based assistance allows various economies of scale and thus will have a cost advantage to deliver an equivalent apartment. Among these are lower vacancy, lower turnover, centralized billing, purchasing, and maintenance

5. *Monitoring costs built in* In property-based assistance, the cost of monitoring is built in to the rent Vouchers have a 7% PHA administrative fee *on top of* the rent, property-based assistance typically pays 5% to 6% management fees *embedded within* the rent. Further, when vouchers are involved, HUD should monitor the administering PHA, an incremental cost

6. *Income diversification* Property-based assistance allows Congress to develop income diversification guidelines to promote mixed-income housing With vouchers, *de facto* income concentration is common, as discussed in Section 3 1(F).

7. *Social service synergy* Property-based assistance brings together residents who have similar needs (especially the elderly and handicapped). It is enormously easier to deliver meals, wellness programs, and social activities to the residents in a single all-elderly property designed for elderly occupancy than it would be to bring those services into a diffuse neighborhood population

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[12]HUD argues that it is incapable of enforcing accountability, which implies only that the compliance monitoring function should be shifted to public or private entities capable of handling it, not that property-based assistance is intrinsically flawed.

8. *Anchoring or improving neighborhoods* When located in marginal or difficult neighborhoods, property-based assisted properties can make a difference in the community by anchoring or improving it A property can provide a better quality of life, for instance by providing security (a common cost in urban HUD properties, and a significant reason why people prefer to live in them) These features do make the housing more expensive than its neighbors, because it is *better* than its neighbors, as such, property-based developments have served and continue to serve as catalysts for neighborhood improvement

Taken together, these differences -- which are *intrinsic* to property-based versus resident-based assistance, and not simply a feature of their current expression -- imply that property-based assistance will generally be better *except* where a particular property is not cost-effective, *or* where enforcement mechanisms have broken down

4.2 If tenant-based assistance should not be done for all properties, under what circumstances will project-based assistance be more effective?

Property-based assistance will be better[13] when:

A. All or most of the residents are elderly (about 27% of the portfolio).
B. A good property is located in a poor neighborhood whose local market rents will not support the full cost of operation (about 11% of the portfolio).
C. The property is (or could easily be) in good or excellent physical condition and still maintain viable rents cheaper than the cost of Section 8 vouchers (about 40% of the portfolio).
D. Vouchers are clearly superior only when (1) the property is too valuable to preserve (2%), (2) the property is too expensive to operate (3%), or (3) the owner is incorrigible (3%).
E. In all other cases, the choice between property-based and resident-based assistance depends on a policy philosophy rather than a decision about economics.
F. All told, property-based assistance will be superior in about 70% of the properties, resident-based assistance will be superior in 8% of the properties, and in the remaining 22%, either system can work well.
G. Property-based assistance could be improved with remedies such as a 'circuit breaker' mechanism to allow the contract administrator to decouple the subsidy when appropriate

A. All or most of the residents are elderly (about 27% of the portfolio). Resident-based assistance is advocated on two grounds choice and property quality In both

[13] All statistics in the section are Recap Advisors rough estimates based on statistical analysis we have performed on two representative subportfolios comprising 400 or more properties apiece, together with some educated guesses about hard-to-quantify statistics (such as the number of incorrigible owners and fatally flawed properties). We wish to emphasize that these estimates of each property class are extremely rough, have not been externally validated, are subject to amendment and revision, and could well be modified based on better information

cases, these are minimal problems in the elderly portfolio, whereas the benefits of property-based assistance (security and long-term preservation) are valuable to elderly residents

- *Choice.* Stripped to its essentials, a voucher or certificate maximizes choice but minimizes security; by contrast, property-based assistance maximizes security and minimizes choice When it comes to housing, the elderly generally prefer security over choice, as residents, they tend to remain in the same complex for as long as possible Hence the elderly strongly prefer the security of property-based assistance over the freedom and insecurity of vouchers or certificates.

- *Property quality* The all-elderly properties are among the best operated, best preserved, most attractive, and most successful in the HUD portfolio. These are good properties with good owners: enforcement and property improvements are not chronic problems Conversely, preserving elderly properties is a significant benefit The private sector is not producing any affordable elderly housing -- indeed, the only all-elderly development consists of market-rate congregate housing or assisted living communities with very high rents Conventional alternatives to existing affordable all-elderly properties are largely non-existent, and the few available are enormously expensive

  Converting to resident-based assistance forfeits the long-term affordability present in all-elderly properties

Resident-based assistance bestows choice (which the elderly value little) but sacrifices security (which the elderly value highly) Resident-based assistance also abandons long-term affordability preservation from a subset of the best properties where conventional alternatives are absent

Property-based assistance clearly makes sense for all-elderly properties[14]

B. *Good properties located in poor neighborhoods whose local market rents will not support the full cost of operation (about 11% of the portfolio).* Because this housing was sited and developed to serve affordable housing needs not met by the local marketplace, it was *by definition* uneconomic. With twenty years' inflation and growth in America, many of these properties have recovered economic value equal to or greater than their debt Many other properties have value less than their debt, but still positive

A few properties, however, are located in neighborhoods where market rents will not support their full cost of operations at the current service level even with zero debt service These properties break down into two basic types

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[14]Recognizing the elderly's desire for continued security, HUD has recently added a displacement-protection feature to its proposed resident-based certificates However, for the reasons outlined in our response to Question 6 1 below, we believe that, by the time such a certificate is crafted into a reality, it will have most of the drawbacks of property-based assistance with few if any of the benefits

- *Urban family* Some properties were built specifically to serve poor urban families These are often located in major cities (or their abutting suburbs), usually in marginal neighborhoods (with low local rents) where security[15] is an additional expense that raises operating costs These properties often emphasize large apartments, and may be the only three- and four-bedroom apartments in their communities Typically they are the best property in their neighborhood, and are a physical anchor for their communities Urban family properties are equally distributed between the older and newer assisted portfolios

- *Rural elderly.* Other properties (chiefly in the newer assisted portfolio) were built specifically to bring together elderly residents in rural communities that could not support elderly housing. Even if located in small towns, most commonly these properties are high-rises (which is more convenient for the elderly but increases operating costs) They provide elderly-specific amenities such as common rooms, supportive services, and in-property activities that are simply unavailable in the surrounding community

In either case, these properties have fulfilled their policy mandate -- they provide good housing in communities where it is desperately needed They are delivering services and a quality of life above what the local market will support

If property-based assistance is withdrawn, one of three things will happen

- The residents will be forced to absorb a higher rent burden (often much higher)
- The state or locality will provide additional resources to keep the housing in its current good condition.
- The property will deteriorate to the (low) level of housing around it

In general, the residents will be unable to accept a significantly higher rent burden, and we are skeptical of the willingness to states or localities to allocate their scarce resources to a purpose which, however noble, is a preservation rather than an initiation activity We thus believe that by far the most common outcome will be gradual deterioration, which erodes the communities these properties were built to serve

C. The property is (or could easily be) in good or excellent physical condition and still maintain viable rents cheaper than the cost of Section 8 vouchers (about 40% of the portfolio). A significant proportion of the older assisted properties have rents that are today below market (because their initial rents were below market and they have received rent increases only under the budget-based method which caps increases at increases in operating costs) These properties, which we estimate comprise a total of about 430,000 apartments (67% of the older assisted portfolio, can be subdivided into two classes

[15]Unlike property-based assistance, vouchers provide no guarantee of a resident's security, so even if the resident's apartment itself is decent, safe, and sanitary, the resident may be at risk getting to and from the apartment

- *Prepayment-viable* properties (about 100,000 apartments) could raise their rents so much that the owner, if allowed to do so, could pay off the HUD mortgage and convert to truly conventional use For about 80% of these, preservation is cheaper than prepayment[16]

- *Rent-suppressed* properties could raise their rents, but not enough to overcome the transaction and transition costs necessary to convert These properties are providing good housing at bargain rents, and will continue to do so indefinitely A few of them are slowly obsolescing and will need capital improvements, if not immediately then over the next several years, but most of these could finance their improvements within the current rent structure and still keep rents below market

Preserving these properties is good policy because it captures the successes and keeps them as affordable housing in their communities It is good economics because it is cheaper (especially using a capital grant/loan) than allowing prepayment and protecting the residents with Section 8 vouchers

D. *Vouchers are clearly superior only when (1) the property is too valuable to preserve (2%), (2) the property is too expensive to operate (3%), or (3) the owner is incorrigible (3%). In all other cases, the decision between property-based and resident-based assistance depends on a policy choice rather than a decision about economics.* Briefly, vouchers are economically superior only in three clearly definable cases:

- *Property too valuable to preserve (2%)* Within the prepayment-viable portfolio are a few properties (perhaps 20,000 apartments total) that are so valuable the cost to preserve them is materially greater than the cost of protecting residents with Section 8 vouchers. Similarly, within the newer assisted portfolio are a few properties (perhaps 25,000 apartments total) where the same conditions apply. These are the best properties, and thus arguments can be advanced they should be preserved even at a slightly higher cost, nevertheless, if the Federal government wishes to limit its expenditures, these properties must be allowed to exit from the affordable housing stock, either by prepayment[17] (for the older assisted) or opting out of Section 8 contract renewal (for the newer assisted)

- *Fatally flawed properties too expensive to operate (3%)* Some properties (perhaps 30,000 apartments between older and newer assisted portfolios) are fatally flawed, either by location, construction, or years of neglect, mismanagement, or lack of resources So

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[16]We have prepared memoranda analyzing the costs and benefits of both preservation and prepayment in great depth. Copies are available from Recap Advisors

[17]Under current law, newer assisted Section 8 AAF properties whose contracts are not renewed will be automatically deregulated, because the regulatory restrictions are contained in the Section 8 Housing Assistance Payments (HAP) contract Older assisted properties have their restrictions in the regulatory agreement, which is coterminous with the mortgage; these properties may deregulate only if they prepay, an action which has, since 1987, been illegal under the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA) and its predecessor, the Emergency Low Income Housing Preservation Act (ELIHPA) In *Cienega Gardens*, the United States Court of Federal Claims recently ruled that LIHPRHA constituted a compensible breach of contract, so if Congress is unwilling to pay the costs of preserving these properties, it must restore the right to prepay

long as viable housing alternatives are available, no rational public-policy argument can be made for keeping these properties open

- *Incorrigible owners (3%)* Some owners abuse the system, the properties, and their residents They harm the properties and do enormous damage to the reputation of affordable housing as an industry and as a social policy Existing enforcement mechanisms are often cumbersome, expensive, and uncertain Far simpler, cheaper, and less prone to litigation is simply to refuse to renew the Section 8 contract Although incorrigibility is sometimes in the eye of the beholder, we believe that perhaps 30,000 apartments are controlled by such owners

We estimate that, taken together, these three categories comprise perhaps 85,000 apartments or about 8% of the total portfolio

E. *For the remaining properties, the economic factors are roughly equal between property-based and resident-based assistance.* For all the remaining apartments -- family properties whose current rents are at or above market, without fatal flaws and able to pay some debt service after marking to market -- the decision between property-based and resident-based assistance comes down to a matter of policy choice, which can be summarized roughly as follows

Is it better to have security and accountability at the property level, at a cost of a continuing regulatory responsibility which may also inhibit property responsiveness, or to have freedom of choice for residents, at a cost of unreported potential hardship and the risk of losing affordability in the future?

Although HUD clearly believes the benefits of choice and relief from regulations outweigh the costs of affordability risk and potential hardship, the ultimate decision rests with Congress

F. *Overall distribution of property-based versus resident-based situations.* Summarizing the preceding analysis yields the following rough distribution

	Older apts	Newer apts	Total apts	Percent of total
Property based is better policy	*505*	*280*	*785*	*70%*
Resident-based is better policy	*51*	*34*	*85*	*8%*
Options are economically equivalent	*94*	*136*	*230*	*22%*
Total portfolios	*650*	*450*	*1,100*	*100%*

G. *Property-based Section 8 should have a 'circuit breaker' allowing immediate conversion to tenant-based vouchers when appropriate* From Congress's perspective, property-based Section 8's chief drawback lies in its lack of portability should the owner misbehave or the property deteriorate so that the residents are, as HUD literature describes it, 'trapped in their apartments' Although this situation may be infrequent in assisted housing (as

compared with public housing, where it is much more common), it is understandably unacceptable.

But property-based assistance has its advantages, some of which are delineated above, and there is no reason why assistance must be property-based *permanently* Congress could enact a form of property-based assistance with an embedded 'circuit breaker' -- a contractual provision whereby, upon the occurrence of an objectively verifiable event (such as material Housing Quality Standards violations which are not cured within a short time), all Section 8 would convert from property-based to resident-based, *at the option of the contract administrator* Such a circuit breaker would pose no threat to good owners, who could prevent their properties from triggering the decoupling precondition, but would provide an enforceable method of dealing with degrading performance

Circuit breakers would be possible in Section 8 only because (1) HUD would be writing new contracts, not trying to impose a new provision in an old contract within the current regulatory agreement[18], and (2) the new reconstituted mortgage would not carry FHA mortgage insurance, so it could not be held economically hostage.

H. To reduce HUD's administrative burdens, any continuation of property-based assistance should also reform its reporting and compliance procedures into a 'post-audit compliance' approach similar to that used for the Low Income Housing Tax Credit (LIHTC). Though property-based assistance has become associated in HUD's mind with a heavily intrusive, process-oriented approach to regulation, it is compatible with alternative reporting and compliance structures, and there are today in the United States more than a half million apartments receiving a Federal property-based subsidy with *no* HUD involvement and *no* process-oriented regulation the properties developed using the LIHTC.

The LIHTC buys down rents by allowing a substantial portion of a property's development cost to be financed with equity that does not require an immediate cash return[19] The LIHTC is allocated to specific apartments and does not travel with the resident. Despite this, it operates with a minimum of regulation, as follows

- Resident eligibility is income-limited to families at or below 60% of area median
- Rents are capped as a deterministic function of apartment size and area median income
- The owner is required to do resident income verification and to maintain income files

[18]The HUD Regulatory Agreement is not a one-way document In exchange for securing the owner's commitment to operate the property under HUD rules, HUD commits to authorize rents sufficient to allow the owner to pay its expenses Some owners faced with foreclosure have successfully challenged HUD in court, arguing that HUD is estopped from foreclosing for default that were caused by HUD's failure to provide adequate resources to run the property From this it follows that *if HUD intends to decouple subsidy, it must completely deregulate property operations and cancel the regulatory agreement*, otherwise it will be exposed to an endless string of lawsuits challenging the foreclosure right of HUD or any successor lender

[19]In this, the LIHTC is most analogous to Section 236, which also buys down rents by lowering the debt service requirements on a portion of a property's development cost Both the LIHTC and Section 236 subsidy are fixed annual subsidies related to the property's cost.

- The owner's rents and tenancy are subject to annual post-event audit by independent auditors If these compliance auditors uncover failure to comply, the owner is subject to financial penalties[20].
- There is no regulation whatsoever of the owner's operating budget, cash flows, or transactions
- Ownership and control are transferable, with the new owner stepping into the economic position of the old owner (including compliance obligations).

This 'post-audit compliance' approach has numerous structural advantages Even though the principal subsidy is Federal (the LIHTC), it requires no direct Federal or HUD involvement Rents and income limits are annually adjusted based on local market factors, as determined by objective criteria (in this case, the area median income) Compliance monitoring is done on an exception basis; owners are required to report out relevant information and are exposed to financial penalties if they fail to comply The owner faces market risk and exposure, both on rents and expenses Because of this, equity investors tend to negotiate strong protections, and to provide ongoing asset management and performance monitoring which in turn tends to keep the properties in good condition, so market forces are harnessed to support ongoing affordability

All of these features make post-audit compliance an attractive tool for mark-to-market properties As discussed in Section 1 1(B) above, if FHA mortgage insurance were involved, the Federal government would have a continuing financial exposure and such a low-regulation system would be impossible; however, *mark-to-market will eliminate the FHA insurance risk for many properties*, which opens up the prospect of converting property-based assistance from process-oriented regulation to post-audit compliance

Question 5: Alternative Proposals

There have been numerous reservations expressed about the HUD proposal.

5.1 What other ideas in structuring mark-to-market or alternative proposals should be considered by this Subcommittee?

The Subcommittee should consider:

A. *Limiting mark-to-market to properties whose rents are above market.*

B *Using capital grant loan and other one-time preservation (or renovation) funding mechanisms which keep rents below market at lower cost than the voucher alternative.*

[20] In LIHTC properties, financial penalties are most directly imposed through recapture of the tax credits, a self-implementing mechanism requiring little enforcement administration that would not be available in post mark-to-market properties Instead Congress would need to create a financial penalty enforceable against the owner or manager, analogous to a performance bond, which could be drawn upon when non-compliance was established Such a bonding structure has proven effective in situations where self-implementing penalties are impossible, such as LIHTC properties owned by large public-fund limited partnerships.

C. *Other means of cutting Section 8 costs by raising average resident contributions without displacing residents (via repeal of Federal preferences and minimum rent, for example)*

D. *Renewing contracts at the minimum rents needed to avoid default so as to capture the maximum discretionary cost savings without triggering mandatory claims.*

E. *Formula debt restructuring with incentives for owners to minimize the writedown.*

F. *Voluntary incentive programs to compensate owners for inaugurating or accepting cost-saving contractual restructurings.*

At the core of HUD's mark-to-market proposals lies an effort to save Federal money with the least displacement, default, and disruption Mark-to-market (at least as defined by HUD) captures virtually all of the affected properties and applies a largely invariant set of resolution mechanisms to them, because it is so sweeping, it precludes other more targeted programs which can be applied to meaningful subsets of the portfolio.

In other contexts, we have argued the necessity for developing a segmented portfolio strategy The recommendations which follow are specific initiatives which apply to particular portfolio segments; they by no means exhaust all the useful possibilities

A. *Limiting mark-to-market to properties whose rents are above market.* Most of the older assisted properties (perhaps 75%), and a few of the newer assisted (perhaps 10%), have rents that today are noticeably *below* market[21]. If the principal purpose of marking to market is to save money -- as HUD states and as we believe Congress intends -- then it requires a leap of faith to conclude that *raising* rents when it is not contractually required will actually save money

HUD has made this leap of faith by asserting that the portfolio (particularly the older assisted) is a collapse waiting to happen because the physical real estate is atrophying beyond repair[22]. Based on our knowledge of literally hundreds of properties nationwide, we dispute this prognosis We believe that the physical condition of the older assisted portfolio includes five types of capital improvements, most of which are deliberate consequences of the regulatory policy:

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[21]Previous statistical analysis has suggested that 85% of the older assisted portfolio is *at or below* market, and that 10% to 15% of the newer assisted portfolio is *at or below* market To be conservative, we have rounded each figure down, so as to identify a subset where the properties are truly *below* market

[22]A critical statistical analysis on which HUD bases its conclusions is the 1993 capital needs assessment study performed on HUD's behalf by Abt Associates of Cambridge, which estimated the portfolio's capital needs backlog according to an inspection protocol, totaled the results, and then assigned a 'stress index' based on the per-apartment totals While not challenging Abt's portfolio selection or its inspectors' methodology, we believe the study erred in two ways: (1) conflating the five different types of capital improvement backlog into a single category called 'deferred maintenance', and (2) incorrectly assuming that deferral was occurring solely because the property lacked the ability to raise rents (and hence to obtain working capital), when in fact much of the deferral was the inevitable (and reversible) consequence of a deliberate HUD regulatory approach to rent restraint

- *Deferred maintenance* such as patchy roofs and siding, landscaping, and paved surfaces
- *Extended life of in-apartment amenities* such as refrigerators, stoves, carpeting, cabinetry, and bathroom ceramic fixtures
- *Unimplemented improvements with favorable paybacks* such as energy conservation
- *Underfunding of replacement reserves* compared with amounts derived from thorough capital needs analysis
- *Absent market amenities* such as clubhouses, microwave ovens, and air conditioning

The first category (deferred maintenance) arises when a property lacks adequate capital (usually as a result of inadequate rents), it is a powerful leading indicator of future financial problems The other four categories are simply the outcome of a HUD regulatory approach which has (up to now) emphasized rent restraint over reinvestment in the real estate), they do not necessarily prefigure financial problems, and they are reversible with a change in regulatory approach

As discussed in Section 4 2(C) above, we dispute the conclusion that only immediate vouchering can reverse the portfolio's inexorable decline. We think that a simple reorientation of regulatory objectives can allow most of this older portfolio to rebuild its market competitiveness without sacrificing affordability, and at a substantially lower cost to the Federal government

Accordingly, we believe that marking to market should be limited to only those properties whose rents today are above market. *This will not only save money, it will cut the mark-to-market workload in half.*

B. *Using capital grant loan and other one-time preservation (or renovation) funding mechanisms.* Within the older assisted portfolio is a solid core of about 100,000 apartments (15% or so of the older assisted inventory) which are such good real estate that they could convert to conventional use if allowed to do so Nearly all of these properties have self-identified themselves by filing Notices of Intent and proceeding under the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA)

Analysis has shown[23] that, for the vast bulk of these properties, *the cost to preserve them is less than the cost of providing vouchers* The cost differential is especially dramatic when comparing prepayment with the capital grant/loan proposal being advanced by the National Housing Trust and other organizations Capital grant/loan is a more robust policy, because it

- Keeps current rents below FMR
- Preserves mixed income housing and prevents economic eviction[24] of higher-income residents
- Includes funds to renovate properties as appropriate

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[23]Comprehensive analysis on this subject has been prepared by Recap Advisors and is available on request
[24]Numerous studies, including those by the HUD Inspector General, have documented that the rent increases implemented under current LIHPRHA decrease affordability for low and moderate income residents of preservation properties Under capital grant/loan, these residents' rents would *not* increase, so the 'economic eviction' impetus would be eliminated

Capital grant/loan saves money, preserves housing, and reduces displacement It makes sense from any perspective

C. Other means of cutting Section 8 costs by raising average resident contributions without displacing residents (via repeal of Federal preferences and minimum rent, for example). Contrary to uninformed impressions, most of the high annual outlay cost of Section 8 arises *not* from its support of above-market rents, *but rather* from rent burden abatement to very low income residents who secured their Section 8 eligibility as a consequence of Federal preferences. Congress could dramatically reduce its ongoing Section 8 outlays without sacrificing apartments from the affordable housing stock by implementing reforms designed to increase the average resident contribution, such as

- Repeal of Federal preferences and gradual restoration of mixed-income housing
- A minimum rent for all households
- Increasing the resident's contribution from 30% to a higher figure
- Phasing down assistance to individual recipients

Some of these reforms would cause hardship among the neediest residents, Congress should move slowly before adopting them Other reforms (e.g. increased resident contribution shares) save money under static Congressional budget scoring assumptions but cost money in the real world because they drive out higher-income residents, Congress should think carefully before enacting any such changes which might backfire

Some of the reforms improve properties as instruments of social policy (e g. repeal of preferences and greater emphasis on mixed-income housing). These initiatives produce social benefits as well as financial ones, and deserve consideration on those grounds

Importantly, *many of the cost-saving initiatives will work better, and be more adjustable, if associated with property-based assistance*, because they allow the contract administrator to look at the property *as a component in a community*, and thus help it fit in with its surroundings

D. Renewing contracts at the minimum rents needed to avoid default so as to capture the maximum discretionary cost savings which nevertheless avoid triggering mandatory claims. Up to now, HUD materials have presented a stark contrast renew all contracts at their current (unacceptable) levels, or mark to market In between these extremes is a third option offer contract renewal on a budget basis at the minimum level necessary to avoid default

From a financial perspective, this no-default mechanism *eliminates*:

- The mandatory outlays associated with FHA insurance claims
- The value destruction associated with assignment and reconstitution
- The need for huge volumes of transactions, and most of the capacity problems they raise
- Risk of displacement or gradual deterioration.

A breakeven-renewal approach represents savings with no costs On a discounted present value, it probably saves almost as much as HUD's proposal, with much less stress

Against this, HUD would note three features that HUD would argue are flaws. We believe each can be addressed incrementally

1. Many properties would still carry rents above market. However, rents would less above market than before, and the above-market component would be limited to the annual cost of avoiding default, therefore it should be no more expensive, on a discounted present value basis, than the net writedown from a mortgage assignment.
2. There would still be property-based regulation, and the consequent need for a contract administrator. As described in Section 4 2(H) above, property-based regulation could be greatly simplified, and vouchers do not eliminate the need for regulation, they simply transfer it outside HUD (and pay a 7% fee for doing so).
3. A breakeven-renewal system does nothing by itself to cull bad owners or bad properties However, bad owners and properties could be culled using the principles outlined in Section 2 2(B) above.

We thus believe these issues can be addressed incrementally and are not by themselves reasons to default and voucher the entire stock.

E. Formula debt restructuring with incentives for owners to minimize the writedown. A formula approach to debt restructuring has numerous advantages in achieving mark-to-market's objectives Formula restructuring

- Is quick.
- Is reliable
- Involves no transaction costs.
- Requires no expansion in HUD capacity.
- Discourages disinvestment and encourages continued effort (because good owners will believe they can survive).

The drawbacks of a formula approach include lack of intrinsic market tension and no intrinsic mechanism to assure that bad owners and bad properties are culled To address these legitimate concerns, the reconstitution formulas could include incentives[25] to the current owner to improve the property's operations, both before and after mark-to-market, as well as to allow the Federal government to share in any recoveries as the property appreciates over time Bad owners and bad properties could be culled by gatekeepers such as those described in Section 1 2(A)

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[25]An example of a formula reconstitution including these incentives is contained within the responses we provided to questions posed by Chairman Lazio of the House Housing Subcommittee, a copy of which is available from Recap Advisors upon request (617-720-5855, Fax 617-720-3722).

HUD has already identified the financial and policy benefits of using joint ventures with new financial partners A formula debt restructuring simply applies the same principles to a joint venture *with the current owner*

F. Voluntary incentive programs to compensate owners for inaugurating or accepting cost-saving contractual restructurings. Beyond these structural approaches, HUD could craft offers to owners to renegotiate their contracts, in ways such as the following

- *Incentives to wean Section 8 LMSA* as described in Section 6 1(D) below
- *New reg recapitalizations* as described in Section 8 1(B) below
- *Shared savings in operating expenses* as has been successfully implemented in a number of contexts, most notably by the Massachusetts Housing Finance Agency (MHFA) on its uninsured Section 236 and analogous properties (see Section 8 1(B) below)

These voluntary incentive programs deliver savings with little if any cost and modest risk Further, because they are consensual, they lend themselves to pilot programs and can be modified in light of experience.

QUESTION 6: MORTGAGE SALES BIDS

As described in the operating framework, HUD would award the bid for a defaulted mortgage based on the highest bid under its 'reflector' sales approach. Further, under its joint venture approach, the framework indicates that maximizing return is its primary objective.

6.1 Should other factors besides maximizing return be considered by HUD in its design of these approaches?

Congress should include among its public-policy objectives:

A. Preserve affordability.
B. Anchor communities by capitalizing good properties to be self-sustaining.
C. Avoid default on below-market mortgages.
D. Find ways to wean properties off Section 8 without forfeiting affordability.
E. Avoid disenfranchising good owners who have developed and operated good properties according to HUD's rules.

We believe these principles make policy sense for the following reasons

A. Preserve affordability at the property level. As discussed in Sections 4 1 and 4 2 above, we believe that preserving affordability at the property level is cost-effective whenever:

- Current rents are below market and the owner would not convert to conventional use
- Current rents are below market and the cost to buy the owner's conversion right is less than the cost of vouchers (as with the LIHPRHA capital grant/loan proposal)
- The property is located in a market with a current or chronic shortage of quality affordable housing (such as large urban areas with development restrictions, such as Boston, Washington, or San Francisco).
- The property is designed for a specialized tenancy (such as the elderly) who are more interested in security than mobility

As discussed in Section 4 2(F) above, this is a significant number of cases, totaling perhaps 70% of the portfolio.

B. Anchor communities by capitalizing good properties to be self-sustaining. The Federal government embarked on programs to develop affordable housing because it believed (correctly) that affordable housing is an element in *rational urban development* Good housing anchors and transforms communities

Ironically, among the properties most vulnerable to mark-to-market are those which were most successfully socially -- good properties in bad neighborhoods These properties *worked* -- they fulfilled the social policy imperatives for which they were created. They are vulnerable to mark-to-market because after marking to market they would generate too little money to pay their operating expenses Said another way, they are too good for their neighborhood Vouchering them out risks forcing those properties to sink economically to the level of dilapidation around them -- an abandonment of the affordability mission which they are now fulfilling

HUD does not contest this risk, but argues that states and cities will preserve their better properties by redirecting some of their newly created community block grant money back into the properties. Based on our experience, we have a much less charitable view of the policy purity of the typical city government. No new incremental Federal funding will be coming into the cities, which will mean that sustaining these properties will compel taking resources away from other city priorities Continuing affordable housing will never be politically appealing when compared with new flashy initiatives, especially when the deterioration will occur slowly, over a period of years, so that the problems will arise only when someone else is mayor

Twenty-five years ago, the Federal government stepped into the role of creating good affordable housing precisely because the states and localities had proved content to ignore the problem We see no evidence that states and localities will be any more forward-thinking today, if anything, budget pressures will tend to make them skimp on the properties, and may indeed accelerate the disinvestment that we referenced in our responses to Question 3 1(C) and 3 1(F) above

C. Avoid default on below-market mortgages (as distinct from 'maximizing return'). As discussed in Section 1 2(B) above, this is a matter of simple economic analysis) For a significant subset of properties, paying to avoid default (especially in the first few years after

marking to market) will be significantly cheaper than accepting assignment, paying the claim, and reconstituting the mortgage (regardless of the debt restructuring method)

D. *Wean properties off Section 8 without forfeiting affordability.* The older assisted portfolio contains 650,000 apartments, of which about two-thirds, or about 430,000 apartments, have Section 8 Loan Management Set Aside (LMSA) Nearly all of these apartments were originally developed without Section 8[26], but over time, operating difficulties (especially the 1974-1976 real estate crunch caused by the Arab Oil Embargo which triggered both an economic recession and a sudden jump in utility costs), led HUD to add LMSA bit by bit, usually to forestall default

Today some of this LMSA is necessary to support property rents above local market conditions, but much of it no longer protects the property; instead it provides *additional* affordability (beyond the basic rent buydown) to those elderly or family households lucky enough to live in an apartment whose rent is not only below local market but also supported by Section 8

In addition to eliminating strictures that inhibit owners and managers from developing communities with mixed income populations, Congress should consider positive incentives to create such mixed communities. This can be done without disruption in several ways

1. Requiring owners to continue serving very low and low income populations but compensating them with incentives based on reductions in Section 8 outlays under those contracts (To accomplish these savings would require, among other things, repeal of Federal preferences)

2. For below-market properties, requiring that voluntary turnover would trigger a partial attrition of the property-based Section 8 subsidy until the property's income mix reached a suitable balance. (The appropriate balance could be set by the local contract administrator, or could be broadly defined by Congress, with the owner free to rent to anyone so long as the income mix stayed within broad bands)

3. Providing financial incentives[27] to owners to re-rent LMSA vacancies to income-eligible families who can afford the budget-based rent without further subsidy. Again, this gradual

[26]Most Section 221(d)(3) BMIR and Section 236 properties were originally developed with little or *no* Section 8 (Some had a minority of their apartments subsidized under rent supplement or RAP as a means of delivering affordability to very low income residents) The Section 221(d)(3) Market Rate/ Rent Supplement properties had Rent Supplement under Section 101 When the Rent Supplement program ran out of appropriations in the late 1970's, HUD offered the affected FHA-insured owners a chance to convert to Section 8 LMSA, about 97% did so
[27]For example, HUD could agree to pay the management agent a one-time termination fee equal to (say) three months' Gross Potential Rent of each voluntarily vacated apartment re-rented without requiring LMSA This termination fee would have to be in addition to the normal management fee Obviously such a fee is cost-effective, since it represents only 5% (3 months divided by 60 months) of the cost of a five-year Section 8 LMSA contract renewal

reduction in Section 8 outlay costs can and should be accomplished over a few years with no involuntary displacement[28]

E. Avoid disenfranchising good owners who have developed and operated good properties according to HUD's rules. As discussed in Section 2 2(B) above, culling incorrigible owners and fatally flawed properties is a crucial objective of *any* HUD portfolio recapitalization mechanism, whether or not it involves marking to market

Having said this, however, we believe that Congress should be fair to good owners who developed and operated their properties under HUD's rules, for several reasons.

- *HUD's complicity in making the properties uneconomic.* The owners involved invested in good faith and have operated their property according to HUD's rules. Many of these properties were uneconomic when they were developed -- as a consequence of deliberate Federal government strategy -- so to be put into default today for an intrinsic flaw seems unfair[29].

  HUD has argued that owners now facing the risk of foreclosure should have no grounds to complain, because they knew the contracts were only twenty years in short, that they should be foreclosed because they are forecloseable We respectfully submit that such a perspective ignores all the initial public-policy intrusions in the development process, and HUD's continuing involvement over the years.

  Owners have never been free to operate their properties to minimize their default risk; they have been constrained by twenty years of HUD regulations Indeed, one can argue that *most* of the vulnerability in the older assisted portfolio is the direct consequence of deliberate HUD policy to restrain rents and minimize capital reinvestment

  HUD thus shares complicity in the inability of some properties to pay their HUD debt service if completed deregulated, yet the mark-to-market unstructured auction proposal gives no recognition to the transactional history

- *The disinvestment risk* As noted in Section 3 1(D) above, owners will disinvest only if they have no reasonable expectation of retaining an ownership interest. The portfolio will undergo marking to market over a five to eight year period, during that time, owners of later properties will be observing the consequences to owners of earlier properties Since

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[28]Conventional apartment complexes average high annual turnover ranging from 45% to 75% of their tenants Budget-based older assisted properties have lower averages -- according to the National Apartment Association, turnover averaged 26% in the most recent year available (1993) Still, these levels are high enough so that, over a period of several years, most of the tenants will change. In properties that receive 100% Section 8 (either LMSA or AAF), turnover is often quite low, but even in these properties it averages 10% to 15% annually (elderly) or 25-35% annually (family), so that, after four to six years, at least half of the tenants have moved out and new residents have moved in

[29]As discussed in our response to Question 2 1(F) above, such intervention would also expose a conventional lender (but possibly not HUD) to litigation under lender liability

the Federal government's objective is to maximize its *multi-year* collections, it makes sense for Congress to act early on in a manner that minimizes disinvestment risk

- *Reinvestment between now and contract expiration.* A portfolio resolution formula that allows good owners to survive (but culls bad ones) would motivate owners to reinvest before their contract expires, and hence increase overall Federal collections

- *Policy implications for continued investment in affordable housing* The Federal government has a continuing policy interest in the creation of affordable housing How Congress deals with investors in properties developed under previous programs has a substantial influence on whether that same financial community will invest in new Federal affordable housing initiatives, because investors in new housing programs judge their risks and benefits based on the treatment of those who invested before them.

  Affordable housing today is being created principally through the Low Income Housing Tax Credit (LIHTC) At the moment, this is an active and largely successful market, creating at least half a million affordable apartments with little or no direct HUD involvement At the same time, investors have justification for being cautious, because the Federal government's record in the last ten years would lead to the conclusion that bargains once made by Congress can be revoked later on

  - The Tax Reform Act of 1986, which denied tax benefits effectively retroactively
  - The 1987 and 1990 preservation acts, which abrogated existing contractual provisions
  - HUD's mark-to-market Operating Framework, which creates high foreclosure risk

  A Congress interested in preserving good will among the investor community (simply out of its own economic self-interest) would give some weight to dealing with older investors in a manner that the marketplace perceives as fair

QUESTION 7: RESIDENT PROTECTIONS

In HUD's operating framework, HUD would provide additional resident protections to prevent displacement. For example, current residents who would receive housing certificates under its proposed Housing Certificate Program would be able to stay in their apartments if they so choose. Also, HUD would protect the elderly and those with disabilities by providing additional amounts of subsidies so they will be able to remain in their current apartment.

7.1 How different is this new certificate program compared to project-based assistance?

Although superior in some cases to non-cancelable property-based assistance (such as many properties now receive), these displacement-protected 'sticky' certificates would probably cost as much or more than property-based assistance while at the same time forfeiting much of

the accountability and control over the owner that HUD can exert when the assistance is truly property-based; on balance, we believe that if Congress wishes to protect elderly residents, a reformed property-based assistance system is clearly superior to an displacement-protected 'sticky' voucher or certificate.

A. Advantages of the displacement-protected certificate For the reasons outlined in Section 1 1(B) above, elimination of the overhanging FHA insurance responsibility is a precondition of the displacement-protected certificate systems Once the mortgages have been marked to market, however, a displacement-protected resident-based certificate has the advantage that the residents can always leave with no loss of subsidy. This gives them a practical leverage which they currently lack (although, as noted in Section 4 1(F) above, a Section 8 circuit breaker would create a similar leverage over a whole property)

B. Disadvantages of the displacement-protected certificate At the same time, decoupling Section 8 subsidy but allowing rental assistance to rise to the subject property's rent levels combines undesirable features of both programs, as follows

- *Higher cost than property-based assistance* This system will prevent displacement only if the contract administrator permits the rents to rise to the subject property's rents Since the administrative fee (7% of rents, a consequential sum) is over and above the rent, this automatically means that HUD is paying a 7% premium for the privilege of portability
- *Vulnerability to rent rises above 'true market'* To prevent owner abuse of this system, the contract administrator will be setting a property-specific payment standard Properties have many different apartment types and often different features or configurations within apartments, as a result, the contractor administrator will be constantly striving to verify whether the rent quoted a certificate holder is the same as would be available to a true market resident

  Verification will be cumbersome, leading to an increase in administrative costs (which, as noted elsewhere, are an additional cost in vouchers) Verification will be especially difficult in properties that concentrate on certificate holders -- and most marked-to-market properties will have a huge concentration of certificate holders, if only because their current residents will not immediately move out The potential for invisible rent inflation is enormous
- *No ongoing affordability protection* When markets tighten, owners will raise rents to keep pace Certificate holders, who are generally perceived as less desirable tenants (if nothing else, because their rent-paying ability depends on a bureaucracy), will be among those whose rents will be raised first and most
- *No protection against condominium conversion* or other alternate uses Once property-based regulation is abandoned, this risk is inherent
- *Gradual degradation of specialized services* Property-based assistance allows continuing property-based regulation, which creates the vehicle to provide ongoing specialized services, especially for elderly residents (the principal beneficiaries of the displacement-proof certificate). When the property is deregulated, the owner no longer has an

economic motivation to provide those services for free or at cost, instead they will become either luxuries (in which case they will be terminated) or profit centers (in which case their price will rise) Either way, the elderly will experience a lower quality of life than they receive today

C. *Relative utility of displacement-protected certificates and property-based Section 8 with circuit breakers* On balance, displacement-protected certificates will probably be inferior to property-based assistance in any property a majority of whose residents would be displacement-protected

Statistical estimates[30] of the mark-to-market universe reveal that the elderly comprise about 55% of the newer assisted portfolio and 25% of the older assisted portfolio, as follows

	Older assisted apartments	Newer assisted apartments	Total portfolio
Total apartments in portfolio	650,000	450,000	1,100,000
All-elderly developments	15%	45%	26%
Elderly residents in family developments	10%	20%	14%
Elderly as a percentage of all residents	23%[31]	55%	37%
All-elderly apartments	92,500	202,500	293,000
Elderly households in family developments	65,000	49,500	114,500
Total elderly households	157,500	252,000	407,500

(These figures *are extremely rough estimates* based on educated guesses)

HUD's proposal would thus involve about 400,000 displacement-proof certificates, of which 290,000 would be in all-elderly developments where the difficulty of establishing true market rents would be most acute

Given this large volume of such apartments, HUD's mark-to-market cost figures should be increased to reflect the increased cost of protecting the elderly from eviction, indeed, we seriously questions where the putative savings and mobility outweigh the many structural disadvantages outlined above Assuming that the typical displacement-proof certificate cost 10% more than a normal certificate, the incremental cost of this feature could easily be as much as $275,000,000[32] annually, a significant amount that would change the cost-benefit relationship on many properties

[30] Analysis performed by Recap Advisors based on the following sources (1) Older assisted portfolio, (a) all-elderly properties counted from the HUD preservation inventory, and (b) elderly in family developments based on an informal survey of Recap Advisors' LIHPRHA clients; (2) Newer assisted portfolio, (a) all-elderly developments extrapolated from a representative portfolio of more than 200 newer assisted properties owned by a single large owner, and (b) elderly in family developments based on a simplifying assumption using apartment distribution and assuming that efficiency and one-bedroom apartments have largely elderly residents

[31] Computed as 15% + ((100%-15%) x 20%).

[32] Calculated as a 10% premium over FMR x $575 (national median monthly Fair Market Rent) x 12 months in a year x 400,000 apartments affected

i New reg restructurings Within the FHA-insured portfolio are approximately 200,000 FHA-insured 'new reg' Section 8 apartments which hold an opportunity for a mutually beneficial renegotiation These properties have the following characteristics

- Long Section 8 AAF contracts coterminous with the mortgage
- Regulatory agreement (the 'new reg' agreement) limits the owner's cash distributions
- Any excess funds must be deposited in the residual receipt account and held until the end of the Section 8 contract
- Before expiration, the owner may draw on residual receipts for approved property costs
- When the Section 8 contract expires, residual receipts *belong to HUD*

These contracts are now mutually dysfunctional HUD provides excessive rents, which generate excess cash flow that is deposited into an account, invested for many years at a rate less than the Federal borrowing rate, and then returned to HUD (if anything is left) Conversely, the owner faces phantom income on these earnings (so is economically motivated to minimize them), has no ownership in them, but *does* own the real estate (so has an economic motivation to reinvest them in the property) The arrangement hurts both parties

The cash flows involved are substantial Analysis of a representative portfolio of 99 properties totaling 10,950 apartments shows that

- 37% are generating $1,000 or more per apartment in annual cash flow
- 20% already have per-apartment accumulated cash of $5,000 or more, with a median of about $8,000 per apartment
- Virtually all properties with high accumulated cash are also generating high cash flow
- These properties are projected to generate $27,500 per apartment in aggregate cash flow between now and contract expiration, or about $1,350 per apartment per year The typical property also has an annual dividend limitation of about $250 per apartment[34] per year, so the properties will generate at least $1,100 per apartment in excess cash flow, for $22,000 in aggregate excess cash flow

HUD could offer owners of new reg properties a renegotiation whereby

- The owner would agree to cancel the AAF rent increase provisions and accept budget-based rents at a level sufficient to generate the limited dividend cash flow (all that the owner is currently entitled to receive from operations)
- HUD would agree to pay the owner a one-time renegotiation fee, out of the residual receipts already accumulated in the property, equal to (say) 15% of the projected outlay savings from the owner's acceptance of budget-basing
- Any remainder in the residual receipts account would immediately be released to HUD

[34] Calculated assuming a $35,000 per apartment original mortgage representing 90% of the approved development cost, with the owner entitled to a 6% annual limited dividend on the imputed 10% equity

Using the above statistics, HUD would pay the typical owner $3,300 per apartment from the property's replacement reserve (15% x $22,000 savings), would receive $4,700 per apartment today, and would save $1,100 per apartment per year thereafter Assuming that 20% of the new reg properties, participated (or about 40,000 apartments), the savings *in outlays* would be $188,000,000 immediately plus $44,000,000 annually for the next twenty years -- *with no* displacement, *no* loss of affordability, *no* claims against the FHA insurance fund, and *no* litigation

ii. Shared savings from operating expense reductions Similarly, both new reg properties and older assisted properties could consider instituting a program to share savings from reduced operating expenses (provided of course that housing quality did not deteriorate) Several state housing finance agencies have successfully experimented with shared-savings programs, which typically provide that the owner (or property manager) receives a non-cumulative additional distribution (or incentive fee) equal to a percentage of any savings in operating expenses For older assisted properties, the incentive fee could be expressed as a percentage of any deposits into the residual receipts account, with the balance rebated directly to HUD

Like the new reg Section 8 contract restructuring option described in the preceding subsection, this voluntary shared-savings program restores economic incentive without compromising the basic principles of property-based assistance and continuing affordability

C. Fear of foreclosure; half a loaf. The owner fears foreclosure at contract expiration and is offered some financial incentive today which may be rescinded as contract expiration approaches. Scenarios are conceivable in which an owner can foresee inevitable foreclosure when the contract expires, but is offered some cash today to quitclaim the property and allow cancellation of the Section 8 contract (For example, a fatally flawed property that nevertheless has a long Section 8 contract)

As with the preceding example, the mere inevitability of foreclosure is not by itself sufficient to cause the owner to accept Section 8 cancellation, rather, HUD will have to offer a financial incentive, either economic (a cancellation fee) or tax (a one-time waiver of capital gain for an early termination) Economic incentives probably require authorization by the HUD authorizing committees, tax incentives require statutory changes approved by the tax-writing committees

Neither incentive is available today, both are largely theoretical

8.2 What would the impact of early termination be on residents and communities?

The impact depends on the reasons for and financial structure of the early termination

A. *Conversion. If the property converted, it would be lost to affordable use, residents would be displaced, and communities would probably lose some of their socioeconomic diversity.*

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MACK FROM WILLIAM E. HAYNSWORTH

Q.1. ***Use of FHA Insurance for Mortgage Sales***—The HUD proposal, as we see it today, would not provide FHA insurance. What impact would insurance have on those loans sold under HUD's "mark-to-market" proposal? What other tools would you recommend for HUD?

A.1. Obviously, if HUD would sell the loans with FHA insurance, more bidders would emerge with higher bid prices resulting, hence a smaller FHA claim.

In terms of other tools, I suggested in my testimony (a copy of which is attached for your convenience) that HUD must demonstrate some flexibility in its approach to the national housing stock. This is particularly true with respect to special needs properties located in more difficult areas. We just don't believe that a rushed "one size fits all" approach is the best way to deal with this critical national resource.

Q.2. ***Impact of Delays***—HUD has stated that "mark-to-market" must be implemented as soon as possible because delays will result in increased costs to the taxpayers and the further deterioration in the neighborhoods where the properties are located. Further, among other concerns, HUD has stated that owners would disinvest in their properties if Congressional action is delayed. What is your reaction to these statements?

A.2. There is no need to do "mark-to-market" today. Most of the Section 8 projects expiring in the next 2 years are Loan Management Set-Aside contracts which typically have rents below the Fair Market Rent. Actually, under HUD's proposal we understand that it would be more costly to provide vouchers to residents of these projects than to continue project-based assistance.

The "oversubsidized" projects which HUD refers to are generally those built under the Section 8 New Construction/Substantial Rehabilitation program. We believe these contracts generally do not begin expiring until 1998, 1999, and beyond.

In our view, the concerns of owners have not received adequate attention in the "mark-to-market" debate. In particular, HUD has largely "ducked" discussion of the potential tax ramifications for owners of implementing "mark-to-market." I dealt with this issue in detail in my testimony before your committee. We believe that a rushed and poorly thought through approach that does not adequately consider the concerns of owners has the much greater risk of leading to widespread disinvestment.

Although the implementation of any new program need not be rushed, because the "mark-to-market" proposal itself has clouded the future of subsidized housing, it is important that the government clarify its position in fairly short order.

Q.3. ***Use of Project-Based Assistance***—The HUD proposal would convert all project-based assistance to tenant-based assistance. Should this be done for all the properties in the portfolio? If not, under what circumstances will project-based assistance be more effective than tenant-based assistance?

A.3. While vouchers have their place in any national housing program, to abandon good quality stock which was built for the sole purpose of providing affordable housing is not sound economic policy. After the rents in the Section 8 projects are marked to market, the cost of vouchers and project-based subsidies will be virtually the same. The difference between the two types of subsidy, according to HUD, is the issue of "choice."

Without project-based subsidies, tenant choice will often mean no home or substandard apartments. Furthermore, voucher conversion will exacerbate the high concentrations of low-income families in certain urban areas.

For elderly and others with special needs a voucher is particularly troublesome. Many of the residents of the Section 8 elderly properties are frail and rely on the supportive services provided by the project. Without these services, many would not be able to live independently, forcing them into a nursing home situation.

Finally, as I stated above in my testimony, there is a group of properties that are well maintained and provide affordable and safe housing in difficult areas. Many of these properties have very high operating costs as a result of their maintenance and safety needs. These properties just wouldn't make it without project-based assistance. The loss of these properties would likely have a devastating effect on their surrounding neighborhoods.

Q.4. ***Alternative Proposals***—There have been numerous reservations expressed about the HUD proposal. What other ideas in structuring "mark-to-market" or alternative proposals should be considered by this Subcommittee?

A.4. The concept of debt restructuring is widely accepted by the industry. It is clear that the lowering of debt on many of the projects is essential. It is HUD's "mark-to-market" framework that is flawed.

Any solution for lowering the debt on these properties must take into account the tax implications to ownership entities, the impact on the community, the effect on the residents, and particularly, the effect such action will have on the financial markets.

HUD's proposal does not mitigate any of these concerns.

I suggested in my testimony that a change be made to the tax code to waive or defer the tax due on the forgiveness of indebtedness that would occur under "mark-to-market." In addition, I now understand that the National Leased Housing Association and others have been working to develop a methodology for accomplishing debt restructuring that will address owners' concerns. It may be possible to lower the debt over a period of time using an interest reducing mechanism. Details will be provided to you shortly by the NLHA.

Q.5. ***Mortgage Sales Bids***—As described in the operating framework, HUD would award the bid for a defaulted mortgage based on the highest bid under its "reflector" sales approach. Further, under its joint ventures approach, the framework indicates that maximizing return is its primary objective. Should other factors, besides maximizing return, be considered by HUD in its design of these approaches?

A.5. HUD should be looking at the long-term effects of its proposals. Maximizing the return to the government initially may ultimately cost the Government much more down the road. Among other things, HUD should consider the effects of its proposals on owners, lenders, tenants, neighborhoods, and cities. If HUD's proposals result in disinvestment in low-income housing, what long-term effects will this have on our national subsidized housing stock and how will it affect the constituencies mentioned above?

Q.6. ***Resident Protections***—In HUD's operating framework, HUD would provide additional resident protections to prevent displacement. For example, current residents who receive housing certificates under its proposed "Housing Certificate Program" would be able to stay in their units if they so choose. Also, HUD would protect the elderly and those with disabilities by providing additional amounts of subsidies so they will be able to remain in their current unit. How different is this new certificate program compared to project-based assistance?

A.6. HUD's proposal only "appears" to protect residents. There is no guarantee that a resident will be able to stay in their unit once they are given a voucher. If an owner chooses to not accept the vouchers, the resident is out shopping for a unit. Furthermore, for family residents, the rents may still be too high and their tenant payment too high for them to afford the unit (even after restructuring). The only way to assure that families can stay in their units is to provide project-based assistance.

Also, the so-called "elderly" protection is deceptive. If the owner converts the project to luxury use, the tenant is forced to leave. Furthermore, if over time, the project certificate residents die or move on and the assistance is not replaced with another voucher holder, the project may not survive.

Q.7. ***Early Termination of Section 8 Contracts***—Under the HUD plan, it states that Section 8 contracts would not be renewed when they expire. However, the plan also indicates that contracts would be terminated early if voluntarily agreed upon by the owners. Under what circumstances do you think an owner would accept early termination of their Section 8 contract? What would the impact of early termination have on residents and communities?

A.7. I find this question difficult to respond to because I can think of few realistic circumstances where an owner would agree to an early termination of his Section 8 contract. I suppose that an occasional property would benefit from an immediate conversion because its market rate rents will exceed its current Section 8 rents. In those circumstances, "mark-to-market" would result in immediate dislocation for tenants which is unlikely to be beneficial to communities.

Section 8 Mark to Market Net Costs and Benefits

under different restructuring assumptions

Prepared on behalf of:
Institute of Real Estate Management (IREM)
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National Assisted Housing Management Association (NAHMA)
National Association of Home Builders (NAHB)
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SECTION 8 MARK-TO-MARKET
NET COSTS AND BENEFITS TO THE FEDERAL GOVERNMENT UNDER DIFFERENT RESTRUCTURING ASSUMPTIONS

EXECUTIVE SUMMARY

The Concept of Marking to Market. Of the 1,339,000 privately owned apartments nationwide financed with HUD assistance, about 800,000 have Section 8 as their principal source of rental income *and* have FHA-insured mortgages. Within this group are many properties whose rents are currently above true market levels (because of their original financing). The Administration is proposing that, as these Section 8 contracts expire, they would be 'marked to market' -- renewed at true market levels. HUD would absorb the rent reduction by restructuring the FHA-insured mortgages with lower debt service that the property could support -- but, to do this, HUD would first have to deal with the mortgagees, who have a right to sell ('assign') their loan to HUD. Thus marking to market has three consequences:

1. It reduces Federal outlays by lowering Section 8 payments.
2. It places a significant claim on the FHA insurance fund from newly defaulted mortgages.
3. It risks displacing many families if the resulting property is not economically viable.

Projected Costs, Benefits, and Family Displacement. We project that marking to market should reduce Federal rental assistance outlays by about $969 million annually, with a total net present value (over a 25-year period) of about $13.7 billion. However, marking to market will have significant costs, in both economic and human terms. Costs will vary depending on policy decisions regarding how to mark to market, and the forms of Section 8 assistance provided:

- *If property-based Section 8 assistance is continued*, marking to market will cost the Federal government about $8.2 billion in net claims against the FHA insurance fund, and will displace as many as 93,000 households.

- *If resident-based Section 8 assistance is substituted*, marking to market will cost about $9.5 billion in net FHA insurance claims, and will displace about 171,000 households.

- *If no assistance at all is provided*, marking to market of the above-market properties alone will cost about $10.1 billion, and will displace 442,000 households, nearly all of those with above-market rents. Also affected would be at least 350,000 more Section 8-assisted apartments (more than $5 billion in FHA-insured mortgages) with rents below market; aside from FHA insurance claims, their residents would be at risk of displacement.

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04/11/95

SECTION 8 MARK-TO-MARKET
NET COSTS AND BENEFITS TO THE FEDERAL GOVERNMENT UNDER DIFFERENT RESTRUCTURING ASSUMPTIONS

PRINCIPAL STATISTICAL FINDINGS

We project[1] that Section 8 marking to market put about $11.6 billion in mortgages (445,000 apartments) into default, after which HUD should be able to recover $3.4 billion in reconstituted mortgages, for a one-time claim to the FHA insurance fund (net of recoveries) of about *$8.2 billion*. About 93,000 apartments will initially have no ability to pay any debt service at all. Unless they are provided some further assistance, they will have to close, forcing 93,000 families into displacement.

These claims will generate an immediate annual outlay savings of about *$969 million*, consisting of $734 million in reduced annual Section 8 payments, plus $235 million annually in recapture of Section 236 interest reduction payments (IRP), for a net payback of about *8.3 years*. At the Federal government's borrowing rate, the total discounted savings over a 25-year holding period are about *$13.7 billion*.

Additional factors could affect costs and benefits:

Situation	Net claim ($bil)	Households displaced
Property-based Section 8 assistance maintained	$8.2	93,000
Conversion to resident-based Section 8 vouchers	$9.5	170,000
No renewals of rental assistance	$10.1	442,000

Immediate termination of all Federal rental assistance would put many more apartments into default than simply those affected by marking to market. At least 350,000 more apartments representing $5.0 billion of FHA-insured mortgages would be affected. Quantifying the total costs of complete cessation of all rental assistance is beyond the scope of this analysis.

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[1] All statistics and analyses in this memorandum are based on the best information available as of April 11, 1995. In several significant areas, data are incomplete and we have relied on estimates generated from smaller databases, which we have then extrapolated to the entire HUD universe. Some uncertainty thus attaches to all these estimates; we reserve the right to amend our projections in light of improved information.

Statistical support[2] for these conclusions is attached as Exhibits 1 through 5

These consequences will play out principally over the five years from FY 1996 through FY 2000, as the Section 8 contracts come up for renewal and restructuring.

The remainder of this memorandum outlines the principal issues and discusses the variables which will affect the net cost and recovery. A description of how we believe mark-to-market will apply at the level of individual properties, together with schematic representations of the changes in income, expenses, Net Operating Income, and potential mortgage recovery, is attached as Appendix A.

PRINCIPAL ISSUES AFFECTING COSTS AND BENEFITS

1. ***Properties Affected by Marking to Market.*** About 1,330,000 apartments nationwide now receive HUD property-based Section 8 rental assistance. They comprise not so much a portfolio as a collection, within which are about ten different families of properties. Not all of the families are suitable for mark-to-market:

- Some properties have long Section 8 contracts that are coterminous with the mortgage and the Federal government has no ability to opt out before then.
- Some properties are financed with uninsured mortgages provided by state housing finance agencies or local issuers. Reducing their rents below breakeven would trigger bond defaults at the state and local level, which in turn raises public policy implications.
- Other properties have FHA insurance but have current rents below market. Rent reduction is inappropriate and unnecessary -- indeed, rent *increases* are probably desirable[3].

These characteristics often overlap in an individual property; many properties have one or more of them. To be meaningful, comparisons of mark-to-market analyses must be based on the same subsets of property involved.

Our analysis has concentrated exclusively on properties where (1) the Section 8 contract is shorter than the mortgage term, (2) the mortgage is FHA insured, and (3) current rents are above market. About 450,000 apartments fall into this subset, or about 33% of the overall Section 8

[2]To simplify and standardize calculations, we have assumed that each property's true market rents are accurately represented by the Section 8 Fair Market Rents applicable to the appropriate Metropolitan Statistical Area (MSA) and apartment types. The reasonableness of FMR's as a proxy for true market rent has been evaluated in numerous studies; in general, we believe that this assumption is reasonable, although for some subsets of properties (such as older budget-based properties) it may be aggressive (and hence understate net costs and benefits from marking to market).

[3]We understand that HUD's formulations of mark-to-market now include the idea of improving these older properties by allowing their rents to rise and deregulating their operations. Analysis of the consequences of such a proposal is excluded from this memorandum.

universe At the same time, some of the policy proposals (in particular, the suggestion that *all* rental assistance should be immediately curtailed) now being advanced go far beyond this subset

Estimates of the ongoing costs of Section 8 tend to lump all forms together Our analysis suggests that renewing the Section 8 contracts *on this set of properties alone* would cost about $4 1 billion annually (including $0 25 billion in continuing Section 236 subsidy), or about $61 6 billion in discounted present value over a 25-year holding period. Marking to market would reduce that to about $3 1 billion annually, for a 25-year discounted present cost of about $47 8 billion, a net savings of about $13 7 billion as cited above

2. ***Renewal Assistance: Property-Based or Resident-Based*** Once rents have been marked to market, property-based Section 8 will lead to greater recoveries (hence lower net costs of marking to market), for three reasons

- With resident-based assistance, vacancy will be at market levels (typically 7.0%) rather than the lower levels maintained by Section 8 properties (typically 2.5%) Net Operating Income is lower.
- Properties that must compete for residents incur additional costs such as advertising, rental concessions, and higher turnover. Net Operating Income is lower.
- With property-based assistance, lenders are more aggressive because they are more confident of future income Debt service coverage ratios are lower, as are lender yield requirements. Both factors increase mortgage resale value per dollar of debt service.

Increased cost if Section 8 is resident-based: at least $1.3 billion.

3. ***The resident population served by Section 8: Potential changes in Federal rental preferences*** The issue of property-based versus resident-based assistance, in the context of the continuation, reform, or repeal of Federal rental preferences, can also affect the net outlay savings from marking to market, because the same Section 8 contract costs more or less money depending on the income of the family who benefits from it. Our analysis has eliminated potential changes in the income mix of Section 8 beneficiaries as a variable.

Under current law, vacancies in Section 8 apartments must be filled first from among applicants who have one or more Federal preferences; only if no qualified Federal preference applicants are available may the owner rent to non-preference residents. Because the preferences emphasize current family hardship, they have the effect of encouraging concentration of the resident mix at the lowest end of the income spectrum. This in turn drives up Section 8 costs

Reforming, reversing, or eliminating Federal preferences would shift resident income mixes over time. Even modest shifts have enormous potential to increase outlay savings. The typical apartment property with property-based Section 8 today has three very low income families for each low income family Changing that resident income mix would decrease the cost of a Section 8 apartment by about $135 per apartment per month, or *$730 million* annually if applied to the 450,000 apartments in our mark-to-market subset Over an assumed 25-year

holding period, the discounted present value over a 25-year holding period is *$8.9 billion* in incremental savings

Increased outlay savings from changing beneficiary mix: as much as $730 million annually, phasing in as the income transition takes hold.

4. ***Renewal Assistance: Section 8 or Nothing*** If instead of offering resident-based assistance, HUD or Congress chooses to have *no* Section 8 at all, net cost to the Federal government will rise significantly, and displacement will skyrocket.

Perhaps 18% of the current residents will be able to afford the market rents. The remaining 82% will have to move Many will not go willingly. Resident-sponsored lawsuits will arise Conversely, owners will either place properties into bankruptcy, sue HUD, or both. More properties will be forced into default. Further, recoveries will fall (because the property will be undergoing a more or less comprehensive turnover in its tenancy)

Total net costs are exceedingly hard to estimate To begin with, even assuming only nominal transition costs, net claims to the FHA insurance fund from just the properties with above-market rents would be about $10.1 billion, with 442,000 families displaced. However, abrupt severance of *all* rental assistance would create turmoil at individual properties, so that even many properties with rents *below* could be forced into default because few if any of their current Section 8-assisted residents could pay current rents, let alone market. At least 350,000 apartments, principally in the older Section 221(d)(3) and 236 properties, with about $5 billion in FHA-insured mortgages, would be affected. Probably most of them would experience default at some level Quantifying such defaults is beyond the scope of the data we have available -- nevertheless we believe they would be enormous.

Additionally, benefit severance would flood the market with newly-deregulated properties, so many apartments would be involved, and so many families displaced, that it would swamp many markets, leading to ripple-effect changes in supply and demand and probably moving market rent levels themselves In our experience, such value deteriorations often cascade, so that their cumulative effect if triggered simultaneously is greater than if they occurred sequentially.

Increase in net cost to the FHA insurance with no Section 8 at all: <u>at least</u> $0.6 billion just for this subset of properties, plus substantially increased claims on the remaining $5 billion of Section 221(d)(3) and Section 236 mortgages.

Displacement is discussed further below

5. ***Paying Claims: Normal Assignment or an Accelerated Procedure*** Under current law, when the mortgage goes into default, the mortgagee is entitled to assign it to HUD (that is, to sell it for 99% of par value) HUD pays the entire claim, then holds the mortgage (now called a HUD-held loan) while it reunderwrites the loan This underwriting period typically takes 12 to 18 months

An assignment costs HUD in several ways

- The current mortgage (which often carries a favorable rate) is lost and the new loan is reconstituted at market rates.
- HUD suffers a significant delay in recovering funds. This increases net costs, plus places a greater strain on the Treasury in the year claims are made.
- HUD field staff, already heavily burdened, see their workload triple Other HUD responsibilities would suffer.

HUD is now studying alternative accelerated claims procedures that would take advantage of the foreknowledge available in this situation[4] Conceivably, HUD could identify properties that it will mark to market, and then offer private-sector underwriters the opportunity to reunderwrite the loan.

This accelerated-recovery procedure would have significant advantages over current law: It would eliminate the delay in recovering funds as well as truncating the cumbersome assignment procedure. Reunderwriting *before* default would also allow better pricing of the new mortgages because the government would be controlling the process rather than being controlled by it. Aside from the administrative and holding costs of having properties in assignment (which we have not quantified, but which HUD estimates as being quite large), the Federal government would experience a delay of as much as two years before recovering its reconstituted mortgages At the Federal borrowing rate (estimated by HUD at 7.68%), the cost of deferring $3.4 billion in receipts for two years is about $0.4 billion.

Increased cost if HUD uses current assignment rather than an accelerated-reassignment procedure: $0.4 billion plus any HUD administrative or holding costs during the interval between default and reassignment.

6. Setting New Market Rents: Formula or Property-Specific. Conventional properties determine true market rents by experimentation -- raising rents and discovering whether increased vacancy results. HUD's mark-to-market program will require an initial rent set not by market experience but rather by an informed estimate. With four to five thousand properties involved, HUD will have to choose either to use a simplistic formula as a proxy for market rent, or to subject each property to detailed property-specific analysis. The former method[5] has the advantage of simplicity and speed, and the disadvantage of inaccuracy.

The consequences of mis-estimating are large. A dollar of monthly rent translates into $11.70 in annual income (at a 2.5% vacancy rate). At a debt service constant of 11.2% (9.5% interest rate, 20 years), a dollar of monthly rent translates into about $104 in mortgage recovery.

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[4]We understand that HUD's calculations of mark-to-market include the assumption that HUD has this accelerated-claims procedure available.

[5]In our analysis, we have made the simplifying assumption that the Section 8 Fair Market Rents (FMR's) reflect actual market rents for these properties.

Increased cost of mis-estimating market rents: approximately $100 in lost recovery for each $1 error in initial monthly rent.

7. ***Underwriting: Internal to HUD or Contracted*** Re-underwriting defaulted mortgages demands expertise in a combination of disciplines construction, management, finance, underwriting, and securitization. Although analogous to underwriting new loans, it has additional features -- resident displacement, operational disruption, potential owner/resident litigation -- which increase its complexity Further, the underwriting will be successful only if the loan stays out of default in the future. There is thus a crucial balance between underwriting too conservatively (which leads to lower-than-optimal recoveries) and underwriting too aggressively (which leads to future defaults and claims that erode originally expected benefits).

Normally underwriting is the province of investment or mortgage banking firms, often in joint venture with large real estate owners or managers In this situation, the existing mortgagee also knows a great deal about the property and has a due diligence advantage in reunderwriting it. That expertise should be brought to bear on these issues To assure that the new loans are secure, however, the underwriters' compensation should be aligned with the Department's long-term net recovery (new loans minus losses on future claims).

Increased cost if HUD underwrites internally rather than contracting with the private sector: Difficult to quantify. Results will vary significantly depending on the compensation systems offered to the reunderwriters.

8. ***Conversion to Market Discipline: Immediate or Transition*** Properties subject to mark-to-market have been operated for at least 15-18 years under regulations whose effect (although not their design) was to atrophy the property's market competitiveness:

- *Section 8 LMSA properties* have budget-based rents. In the annual review, HUD was charged with the responsibility of holding resident rents as low as possible. Whenever a choice had to be made between improving the property and restraining rents, the property suffered Now these properties, although functional, have older appliances, carpeting, cabinetry, and fewer amenities. In other words, the budget-based rent structure shut the property out of the normal ongoi[illegible] [illegible]vations and improvements which conventional properties achieve Its market competitiveness has atrophied

- *Section 8 AAF properties* have rents that are in many cases high above market These properties have more than enough cash to operate ... yet (when there is a limited dividend) the owner does not benefit from the excess cash (and often suffers through phantom income tax). As a result, these properties are usually in excellent physical condition and can compete for market residents, but little effort has been made to optimize operations and minimize operating costs.

Converting either class of properties immediately to pure market use without a period of transition will significantly increase net costs to the Federal government with no compensating benefit whatsoever, because

- More properties will default as residents' rent-paying ability is severely cut.
- Transition costs will substantially increase as residents fight eviction.
- Investors will shy away from reinvesting in these properties
- Mortgage recoveries will be significantly lower.

Stopping abruptly makes no economic sense and is economically unjustifiable.

9. Properties with Zero Cash Flow: Close, Give Away, or Support Some properties will have no ability to pay current debt service. Within this set are three kinds of properties:

1. Unacceptable properties, whose construction, location, or ownership are fundamentally flawed. These should be given away, closed, or demolished

2. Earning-suppressed properties which can recover to operational viability if given time. These should be allowed a reasonable transition period, and perhaps supported with modest renovation loans, so that they can reposition themselves to be viable in a competitive market.

3. Good properties whose sole flaw is that their locations will not support market rate housing. These include both inner-city locations, where the affordable property is the neighborhood anchor, and rural locations. In both situations, the housing alternative is considerably less attractive than the subject property. In many cases, *no* acceptable housing alternatives exist.

The reunderwriting process should cull unacceptable properties, allow transition to the earning-suppressed properties, and support the good properties. Anecdotal evidence suggests that perhaps three-quarters of those with zero initial cash flow potential are nevertheless sound properties which would recover.

Potential increased displacement if good properties are not supported: 70,000 families[6]. *Cost to support such properties: probably about $50 million annually*[7] *(in operating subsidy) until the properties regain operational viability.*

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[6]As shown in Exhibits 1 and 5, our analysis suggests that, assuming continuation of property-based assistance, about 93,000 apartments will have zero initial Net Operating Income, three-quarters of this is about 69,700 apartments.

[7]Properties that are now healthy are by definition paying their full debt service Assuming a continuation of property-based assistance, marking to market will cost them lost earning power equal to the rent differential. Zero-cash flow properties, therefore, have negative Net Operating Income somewhere between $1 and the lost rent; if we assume that the typical zero-cash flow property is midway between these two extremes, the aggregate operating deficits for the 69,700 salvageable properties would be about $47.9 million annually, as shown in Exhibit 5.

10. Protecting Owners' Economic Positions: Cash Flow and Tax Consequences However the finances are restructured, the properties will remain Their long-term value, and their utility to their neighborhoods and their residents, will depend on motivating owners Mark-to-market is fraught with legal obstacles which could be mounted by owners threatened with dire economic consequences Accordingly, we believe that sound public policy requires culling unacceptable owners but protecting those who have operated their properties well and according to HUD's rules. This implies two specific elements

- *Economic equity after recapitalization* After the mortgages are reconstituted, the owner should have a reasonable expectation of earning an initial cash flow equal to the original limited dividend This equity component will assure the owner's motivation

- *Protection against Federal income taxes* In general, debt forgiven by a lender is taxable income to the borrower. Such a result here would be grossly unfair and would eliminate any motivation for owners to cooperate in the recapitalization. Finally, taxes from such income are not included in CBO or other budget projections, so their waiver would represent no net outflow in Federal budgetary terms.

DISPLACEMENT OF LOW-INCOME HOUSEHOLDS

Displacement is harder to quantify Our statistics suggest the following dynamics:

- About 53,500 apartments, or about 6% of the Section 8 inventory, would have true market rents above the Section 8 FMR. Even though these apartments will not necessarily go into default, hence will not have their mortgages restructured, converting to Section 8 vouchers would probably result in eventual displacement of these households. Conversely, if property-based assistance is retained, we believe that these apartments would stay in the affordable inventory, so the families involved would not be displaced

- Displacement will also occur when properties which have no ability to generate cash flow are not supported in some way In the most favorable scenario (property-based Section 8), there are nevertheless 93,000 of t. . apartments With resident-based assistance, there are 117,500 such apartments.

- Finally, if Congress completely abandons Section 8, and terminates contracts with no renewal whatsoever, many households will be unable to pay the resulting market rents, so that even though the properties survive, the residents are forced to move The median Section 8 FMR ($575 per month) is affordable by families with income of 60% or more of the national median of $41,200 (family of four) Statistics compiled in other contexts suggest that of the households receiving Section 8, only about 15-18% have income at 60% of area median or higher On those percentages, a further 272,000 households would be displaced if their Section 8 were terminated

These conclusions are applied to the three primary scenarios as follows

Property-Based Assistance: 93,000 households If assistance remains property-based, and assuming that new rents are set at true market (so the owners do not prepay and escape HUD regulation entirely), displacement will occur only if the properties have zero cash flow and if HUD or Congress then decides not to support them. Our projections suggest that 93,000 apartments will fall into this category, although as noted elsewhere, we believe that all but 25% of these (or about 23,500 apartments) are good properties that should be funded at the margin

Resident-Based Assistance: 171,000 households With a shift to resident-based assistance, the categories of displaced households expands. In addition to the 93,000 households likely to be displaced because their properties will generate too little money to operate, another smaller subset of properties, which would have been viable if assistance remained property-based, will be forced into closure (about 24,500 apartments, for a total of 117,500 apartments with zero cash flow). A meaningful subset of the best properties (we estimate 53,500 apartments) will have rents higher than Section 8 voucher levels, and will displace up to that many voucher holders in favor of renters who can pay true market. Total displacement is projected to be 171,000 households.

No Assistance at All: 442,000 households This scenario involves the most sweeping displacement, arising from three different factors. Good properties will convert to market use; properties with little or no cash flow may close. Either way, all but the most affluent current-resident households will be unable to afford the new market rents. Between prepayment of properties above market (53,500 households), zero-cash-flow properties (117,500 households), and residents living in properties that will still be economically viable but who cannot pay market rents (272,000 households), the total displacement is projected to be 442,000 households.

Displacement statistics may thus be summarized as follows

Category of properties	Displacement consequences	Apartments
Market rents above FMR	Displaced unless property-based	53,500
Zero cash flow with property-based	Displaced unless properties supported	+93,000
Zero cash flow only if resident-based	Displaced only if vouchers immediately	+24,500
Incapable of paying market rent	Displaced if Section 8 terminated	+272,000
Total households potentially at risk (depending on circumstances)		442,000

A total of 442,000 households are potentially at risk.

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SECTION 8 MARK-TO-MARKET
DERIVATION OF STATISTICS AND ASSUMPTIONS

The Mark-to-market Subset

HUD's portfolio statistics indicate that a total of about 1,330,000 apartments receive property-based Section 8. From these, we eliminated any apartments which

- Were financed without FHA insurance.
- Have long Section 8 contracts coterminous with their mortgages.
- Have less than half their apartments assisted with Section 8.
- Have current rents below market (that is, below the Section 8 FMR).

The resulting mark-to-market subset represents about 450,000 apartments, of which just under 100,000 are the older properties (Sections 221(d)(3) and 236) and 350,000 are the newer cohort (Section 221(d)(4) with AAF Section 8).

Extrapolating from Individual Properties to an Aggregate Portfolio

On behalf of a single large client, Recap Advisors has access to individual property data (audited financial statements, actual rent schedules, location and physical configuration) on a national portfolio of about 450 properties comprising 57,500 apartments. From these properties, we extracted all those with the same criteria as our mark-to-market subset, a subset of 36,500 apartments. We performed individual default-and-reunderwriting analyses on each selected property. From this we derived the statistics on rent levels, default rates, mortgage balances, mortgage recoveries, and so on which we used in extrapolating to the full HUD universe. These statistical conclusions in effect formed the basis of our assumptions at the HUD portfolio level.

Critical Assumptions Made in the Analysis

In preparing property analyses and the portfolio summary, we used the following principal assumptions.

- The Recap portfolio subset fairly reflects the overall HUD portfolio. (We have studied this portfolio frequently and in a variety of contexts, and while it exhibits greater internal similarity than HUD's portfolio, we believe that conclusions drawn from it fairly reflect the overall HUD universe.)
- Each property's true market rent is the area Section 8 Fair Market Rent (FMR), both newer properties (221(d)(4) with AAF Section 8) and for older (221(d)(3) or 236 with LMSA Section 8).
- No additional renovations or r[illegible]o are required. (For the older properties, this is probably optimistic.)
- Recapitalized Section 236 properties recapture their interest reduction payment (IRP) subsidy instead of using it to support a higher new loan. Correspondingly, IRP recapture is counted as savings.
- The projection period -- the period over which HUD is assisting the apartments -- is 25 years.
- Inflation over the projection period will be 3% per year for rents, expenses, and costs.
- The Federal government's borrowing rate over the projection period will be 7.68% per year
- About 78% of the older properties are Section 236.

The last four assumptions were taken from HUD's mark-to-market analysis as supplied to us.

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Exhibit 1
HUD's Budget Proposals

Property-based Assistance?	Yes
Accelerated claim payment?	Yes

Marking Section 8 Properties to Market

Estimated Total Cost to the Federal Government

	LMSA Budget	AAF old reg	AAF new reg	Total
Total FHA-insured apartments	633,000	347,400	25,600	1,006,000
Percentage with more than 50% Section 8	68%	100%	100%	80%
Apartments affected by marking to market	430,440	347,400	25,600	803,440
Mortgage per apartment	14,500	29,600	37,300	21,800
Total mortgages (in 1,000,000 's)	$6,241.4	$10,283.0	$954.9	$17,479.3
Rents as a percent of FMR	84%	127%	136%	104%
Percent of properties above FMR	23%	94%	92%	56%
Percent of properties that will default	23%	93%	91%	55%
Average net HUD claim per apartment	13,800	18,000	24,900	17,400
Average recovery per apartment *Note 1*	0	0	0	0
Percent of assignments with zero value	41%	15%	17%	21%
Percent of portfolio with zero value	9%	14%	15%	12%
Total Section 8 apartments	430,440	347,400	25,600	803,440
Apartments above FMR	99,001	326,556	23,552	449,109
Apartments that will default	99,001	323,082	23,296	445,379
Total claims (in 1,000,000 's)	$1,366.2	$5,815.5	$580.1	$7,761.8
Total recoveries (in 1,000,000 's)	$0.0	$0.0	$0.0	$0.0
Apartments with zero value	40,590	48,462	3,960	93,013

Given these assumptions, 445,400 apartments will default, triggering $7.8 billion in net claims. HUD will then recover $0.0 billion in reassigned mortgages (net of holding costs), for **a net loss to the Federal government of** **$7.8 billion**

For background on the statistics and assumptions from which this analysis was derived, see the accompanying "Derivation of Statistics and Assumptions," which is an integral part of this schedule.

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Note 1 This projection assumes that HUD incurs no holding or disposition costs (because it can reassign the mortgages immediately upon default and never take them into the HUD-held inventory). To do so requires changes to current law, which the Administration intends to seek.

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Exhibit 2
No Changes to Current Law

Property-based Assistance?	Yes	
Accelerated claim payment?		No

Marking Section 8 Properties to Market

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Rents as a percent of FMR	84%	127%	136%	104%
Percent of properties above FMR	23%	94%	92%	56%
Percent of properties that will default	23%	93%	91%	55%
Average net HUD claim per apt *Note 2*	16,300	28,400	35,200	26,100
Average holding period lost value per apartment	*300*	*1,100*	*1,100*	900
Average recovery per apartment *Note 1*	2,500	10,400	10,300	7,700
Percent of assignments with zero value	41%	15%	17%	21%
Percent of portfolio with zero value	9%	14%	15%	12%
Total Section 8 apartments	430,440	347,400	25,600	803,440
Apartments above FMR	99,001	326,556	23,552	449,109
Apartments that will default	99,001	323,082	23,296	445,379
Total claims (in 1,000,000 's)	$1,613.7	$9,175.5	$820.0	$11,609.3
Total net recoveries (in 1,000,000 's)	$217.8	$3,004.7	$214.3	$3,436.8
Apartments with zero value	40,590	48,462	3,960	93,013

Given these assumptions, 445,400 apartments will default, triggering $11.6 billion in net claims. HUD will then recover $3.4 billion in reassigned mortgages (net of holding costs), for **a net loss to the Federal government of** **$8.2 billion**

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Note 1. This projection assumes HUD's normal assignment procedure, which involves (1) assignment, (2) HUD itself underwriting the reconstituted loan, and (3) reassignment after 18 months. The projected holding period cost represents the lost present value resulting from selling the mortgages later

Note 2 The average claim paid on LMSA properties *is higher than* the average mortgage, because LMSA properties with larger mortgages are more likely to need above-market rents to break even.

Exhibit 3
Vouchers Immediately

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Property-based Assistance?	No
Accelerated claim payment?	No

Marking Section 8 Properties to Market

Estimated Total Cost to the Federal Government

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Percent of properties that will default	23%	93%	91%	55%
Average net HUD claim per apt *Note 2*	16,300	28,400	35,200	26,100
Average holding period lost value per apartment	*200*	*600*	*600*	500
Average recovery per apartment *Note 1*	1,500	6,400	6,200	4,800
Percent of assignments with zero value	53%	18%	29%	26%
Percent of portfolio with zero value	12%	17%	26%	15%
Total Section 8 apartments	430,440	347,400	25,600	803,440
Apartments above FMR	99,001	326,556	23,552	449,109
Apartments that will default	99,001	323,082	23,296	445,379
Total claims (in 1,000,000 's)	$1,613.7	$9,175.5	$820.0	$11,609.3
Total net recoveries (in 1,000,000 's)	$128.7	$1,873.9	$130.5	$2,133.0
Apartments with zero value	52,471	58,155	6,756	117,381

Given these assumptions, 445,400 apartments will default, triggering $11.6 billion in net claims. HUD will then recover $2.1 billion in reassigned mortgages (net of holding costs), for **a net loss to the Federal government of** **$9.5 billion**

For background on the statistics and assumptions from which this analysis was derived, see the accompanying "Derivation of Statistics and Assumptions," which is an integral part of this schedule.

Note 1: This projection assumes that mark-to-market is accompanied by immediate conversion to tenant-based assistance. As a result, the property has higher vacancy and operating expenses, leading to lower recovery when the loans are reconstituted.

Note 2: The average claim paid on LMSA properties *is higher than* the average mortgage, because LMSA properties with larger mortgages are more likely to need above-market rents to break even.

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Exhibit 4
No Section 8 At All

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Property-based Assistance?	**None!**
Accelerated claim payment?	No

Marking Section 8 Properties to Market

Estimated Total Cost to the Federal Government

	LMSA Budget	AAF old reg	AAF new reg	Total
Total FHA-insured apartments	633,000	347,400	25,600	1,006,000
Percentage with more than 50% Section 8	68%	100%	100%	80%
Apartments affected by marking to market	430,440	347,400	25,600	803,440
Mortgage per apartment	14,500	29,600	37,300	21,800
Total mortgages (in 1,000,000 's)	$6,241.4	$10,283.0	$954.9	$17,479.3
Rents as a percent of FMR	84%	127%	136%	104%
Percent of properties above FMR	23%	94%	92%	56%
Percent of properties that will default *Note 3*	23%	93%	91%	55%
Average net HUD claim per apt *Note 2*	16,700	28,600	35,900	26,300
Average holding period lost value per apartment	*0*	*600*	*400*	500
Average recovery per apartment *Note 1*	0	5,400	4,100	3,700
Percent of assignments with zero value	63%	24%	34%	33%
Percent of portfolio with zero value	14%	22%	31%	18%
Total Sectio.. 8 apartments	430,440	347,400	25,600	803,440
Apartments above FMR	99,001	326,556	23,552	449,109
Apartments that will default *Note 3*	99,001	323,082	23,296	445,379
Total claims (in 1,000,000 's)	$1,653.3	$9,240.1	$836.3	$11,729.8
Total net recoveries (in 1,000,000 's)	$0.0	$1,550.8	$86.2	$1,637.0
Apartments with zero value	62,371	77,540	7,921	147,831

Given these assumptions, 445,400 apartments will default, triggering $11.7 billion in net claims. HUD will then recover $1.6 billion in reassigned mortgages (net of holding costs), for **a net loss to the Federal government of** **$10.1 billion**

For background on the statistics and assumptions from which this analysis was derived, see the accompanying "Derivation of Statistics and Assumptions," which is an integral part of this schedule.

Note 1: In this projection, Section 8 is terminated and there is no subsidy at all for the residents. Not only do more apartments fail, virtually all the residents would be immediately displaced.

Note 2. The average claim paid on LMSA properties *is higher than* the average mortgage, because LMSA properties with larger mortgages are more likely to need above-market rents to break even.

Note 3 **Actual defaults would be substantially higher than this - added defaults would come principally from properties with rents below market - but we lack data to make a reliable projection.**

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Exhibit 5
Outlay Savings and Families Displaced

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Marking Section 8 Properties to Market

Estimated Savings and Displacement

Outlay Savings	LMSA Budget	AAF old reg	AAF new reg	Total
Total FHA-insured apartments	633,000	347,400	25,600	1,006,000
Percentage with more than 50% Section 8	68%	100%	100%	80%
Apartments affected by marking to market	430,440	347,400	25,600	803,440
Percentage of such properties Section 236	78%	0%	0%	
Total Section 236 apartments	335,743	0	0	
Annual Section 236 subsidy per apartment	700	0	0	
Median national Section 8 Fair Market Rent	575	575	575	
Percent of apartments above FMR	23%	94%	92%	56%
Average rent of such properties	110%	127%	135%	12%
Apartments with rents above FMR	99,001	326,556	23,552	449,109
Monthly rent savings per apartment	58	155	201	1,837,100
Annual outlay saving (in 1,000,000 's)	68.3	608.4	56.9	733.6
Annual Section 236 IRP recapture (in 1,000,000	235.0	0.0	0.0	235.0
Annual outlay savings in first year	**$968.6 million**			

Displacement of Low-Income Families		LMSA Budget	AAF old reg	AAF new reg	Total
Percent whose true market rents are above FMR		4%	10%	6%	
Apartments whose market rents are above FMR		17,218	34,740	1,536	53,494
Apartments with zero value: property-based		40,590	48,462	3,960	93,012
Apartments with zero value: resident-based		52,471	58,155	6,756	117,382
Apartments with value: resident-based		46,530	268,401	16,796	331,727
Residents who cannot afford market:	*82%*	38,155	220,089	13,773	272,016
Households displaced: property-based assistance		40,590	48,462	3,960	93,012
Households displaced: resident-based assistance		69,689	92,895	8,292	170,876
Households displaced: no assistance at all		107,843	312,984	22,065	442,892
Zero-val .e apts worth keeping open	*75%*	30,443	36,347	2,970	69,759
Average operating deficit/ apartment	*50%*	345	931	1,208	687
Cost to keep zero-value properties viable		10.5	33.9	3.6	47.9

For background on the statistics and assumptions from which this analysis was derived, see the accompanying "Derivation of Statistics and Assumptions," which is an integral part of this schedule.

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Note 1. Households displaced under each scenario are the following groups:
1 Property-based. Only properties with zero cash flow (Above-FMR properties get true market rents.) Refinements could also reduce this figure.
2 Resident-based All above-FMR properties and all those with zero cash flow
3 No assistance Everyone except those who can pay true market today

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04/11/95

APPENDIX A

MARKING SECTION 8 RENTS TO MARKET
HOW IT WORKS

SUMMARY

Marking to market of Section 8 assisted properties involves:

- Identifying properties whose rents are above market.
- Lowering the rents and thus reducing the properties' ability to pay debt service.
- Causing or anticipating a default in the loan.
- Restructuring the new lower debt service into a reconstituted or recovered mortgage.

At its heart, mark-to-market is a financial transaction involving a one-time investment (the net claim to the FHA insurance fund) and a long-term recovery (savings in Section 8 subsidy payments). Resolution of important policy questions in the mark-to-market approach will make billion-dollar differences in the Federal government's net cost, and can in turn determine whether marking to market makes good economic sense.

This memorandum describes the Administration's proposed procedure by which properties could be marked to market and, in so doing, identifies the key policy questions whose answers will dictate the Federal government's net cost.

MARKING AN INDIVIDUAL PROPERTY TO MARKET

Because each property is a separate legal and economic entity, mark-to-market must be applied *property by property*, via a procedure that involves seven basic steps:

Step 1: Identify properties with above-market rents. Those whose current rents are below market will be culled from this process (although they may be subject to other deregulation or rent restructuring under a different programmatic approach).

Step 2: Establish new (lower) market rents The property's rents must reflect actual market conditions: if they are too high, the Federal government will continue oversubsidizing the property; if too low, the mortgage writedown will be unnecessarily expensive At the same time, the properties have had many years of insulation from the market, so they may lack operating practice that would strengthen their market position Finally, market rents are location-specific -- within a given Metropolitan Statistical Area (MSA) may be a dozen distinct submarkets with different rent levels. If the underwriting is done property by property, it requires enormous resources and careful diligence which slows disposition. Conversely, if it is done broadly, applying a general formula (such as Section 8 Fair Market Rents), it risks inaccuracy.

Step 3: Satisfy the current mortgagee A few properties whose current rents are above market have enough cash flow to keep paying their current debt service even after the rent reduction. Nevertheless, most do not: reducing their rents will make the property unable to service its debt and will give the FHA-insured mortgagee the right to assign the loan (for 99% of par), which it will probably elect (because most of these loans carry below-market interest rates)

If the mortgage lacks FHA insurance (such as many state housing finance agency or local tax-exempt 11(b) bond properties), the issues become more complicated since a third-party mortgagee is involved. No methodology has yet been identified to handle these properties equitably

Step 4: Determining the new Net Operating Income. Once the new rents are set, the property's ability to pay debt service depends on its new Net Operating Income, which takes into consideration vacancy, operating expenses, reserves and renovation, and the owner's cash flow Each of these raises issues, as follows:

- *Vacancy*: If the Section 8 assistance remains property-based, vacancy will probably remain unchanged at its current low levels If the Section 8 becomes tenant-based, vacancy will rise to market levels. If there is *no* replacement Section 8 at all, vacancy and displacement will be huge.

- *Operating expenses*: Properties insulated from the market may have some less than optimal practices Conversely, they have little if any advertising and renting costs, and lower turnover (an expensive category).

- *Reserves and renovation* Older properties with dividend limitations and budget-based rents often have done less ongoing renovation, because the current system actively discourages it. If these properties are to compete effectively in the market, they will need renovations Older properties also have rising ongoing replacement requirements, so their reserve deposits should also rise

- *Owners' cash flow*: Essential to the success of marking to market will be to secure the cooperation and economic motivation of owners; failure to do so will substantially increase claims to the FHA insurance fund Hence the owner should have a reasonable expectation of generating cash flow after the recapitalization.

Step 5: Establish new debt service Net Operating Income never translates dollar-for-dollar into new debt service -- lenders require a bit of 'debt service coverage' (typically ranging from 110% to 140%) If the reunderwriting has no FHA insurance, the coverage must be greater So NOI must be reduced by coverage to establish a suitable new debt service level.

Some properties will have no ability, initially or even after repositioning, to generate debt service. A few of these properties deserve to be closed or demolished. Many others simply suffer the misfortune of being located in areas with low market rents (inner cities or rural locations). Many of these should be kept open, because they are good properties and the marginal cost to do so is small. Provision should be built into the system for coping with such properties

Step 6: Structure the new mortgage Structuring the new mortgage involves determining the interest rate, remaining term, and the FHA insurance. This step interrelates with the preceding one, since lenders who are highly confident of repayment will require a lower interest rate and lower debt service coverage, hence pay a higher price.

As noted in Step 3 above, uninsured mortgages complicate the picture and have not yet been addressed.

Step 7: Sell the new mortgages Under current procedures, HUD becomes the mortgagee and holds the loan while it internally attempts to restructure it. This process has historically taken a long time (15 months is typical) and costs HUD large holding period costs. Finding a transaction which pays the mortgagee in full but prevents the loan actually coming into the HUD inventory would significantly reduce the FHA insurance fund's net costs. So would having access to capable private-sector financiers and mortgage underwriters.

The preceding discussion should illuminate that not only does marking to market involve many policy issues, the steps in each property have an iterative component, as later steps impact on decisions made previously Any mark-to-market strategy should be well thought through and carefully tested *before* it is implemented on thousands of properties nationwide.

PRINCIPAL ISSUES THAT ARISE IN MARKING TO MARKET

The following table illustrates the principal issues that arise in each of the seven steps. (As noted above, these decisions are interactive and iterative -- they affect each other.)

Step	*Activity*	*Policy Questions Raised in this Step*
Step 1	Identify above-market properties	• Should below-market properties be restructured also, and if so, how?
Step 2	Determine new market rents	• Formula or property-specific? • Are properties allowed a transition? • Who does it?

Step	Activity	Policy Questions Raised in this Step
Step 3	Satisfy old mortgagee *Absorb claim in FHA insurance fund*	• If no default, no cost to HUD. • If default, full assignment, Partial Payment of Claim, or a new hybrid? • What if mortgage has no FHA insurance (e.g. state HFA)?
Step 4	Determine new Net Operating Income	• Section 8 property- or tenant-based? • Changes in operating budget? • Need for repairs or renovations? • Increased reserves?
Step 5	Establish new debt service	• Protect owners' cash flow? • What level of coverage? • What happens to properties with zero cash flow?
Step 6	Price new mortgages	• New FHA insurance or not? • What happens to reduced debt? • Owners' tax consequences?
Step 7	Sell new mortgages *Recover against old claims*	• Are properties held in HUD inventory? • Who sells the loans?

OTHER IMPORTANT CONSIDERATIONS

In addition to the financial questions are other important considerations such as:

- Will this 'purely financial' transaction have operational consequences that impair owners' contract rights or disrupt the residents' quality of life?

- Can this restructuring be managed without legal consequences to the Federal government? Specifically, what are the risks of litigation by owners, lenders, residents, or communities?

- Will the financial restructuring (and owners' efforts to compensate for lost revenue) trigger a cascading effect whereby property operations suffer, leading to losses greater than suggested by a 'hold harmless' approach?

- Will properties that have had their rents reset to true market and their debt restructured continue to be subject to HUD regulation? If so, how?

- How will the debt writedown be handled? Will it survive as an accruing mortgage? If not, how do owners avoid Federal income taxes on cancellation of indebtedness? Conversely, if it *does* survive, how will HUD motivate owners and managers to maintain and improve the properties?

Conclusion

Mark-to-market involves a radical overhaul of as many as 5,000 HUD-insured and HUD-assisted properties nationwide, representing a total inventory of $15 billion in FHA insurance. Financial consequences will run into billions of dollars. Some mark-to-market approaches make significantly more economic sense than others. Any proposed mark-to-market and reunderwriting structure should be tested against portfolios of sample properties to determine the projected consequences to the FHA insurance fund.

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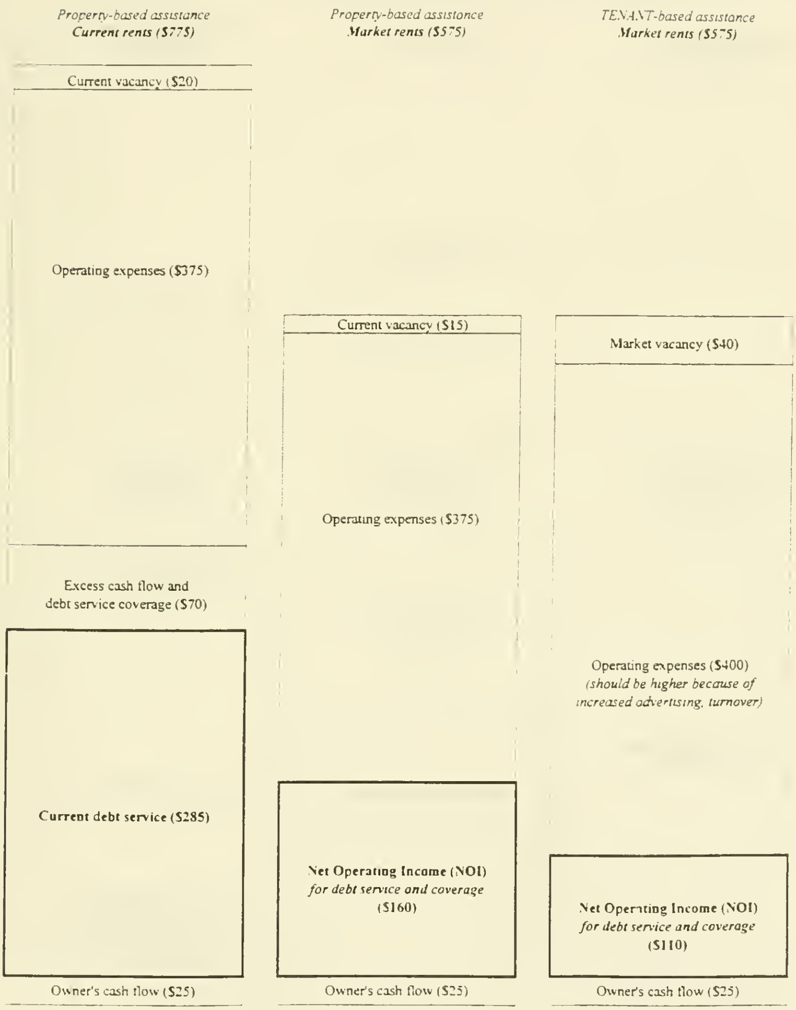
Marking Section 8 Rents to Market

Changes in Monthly Debt Service

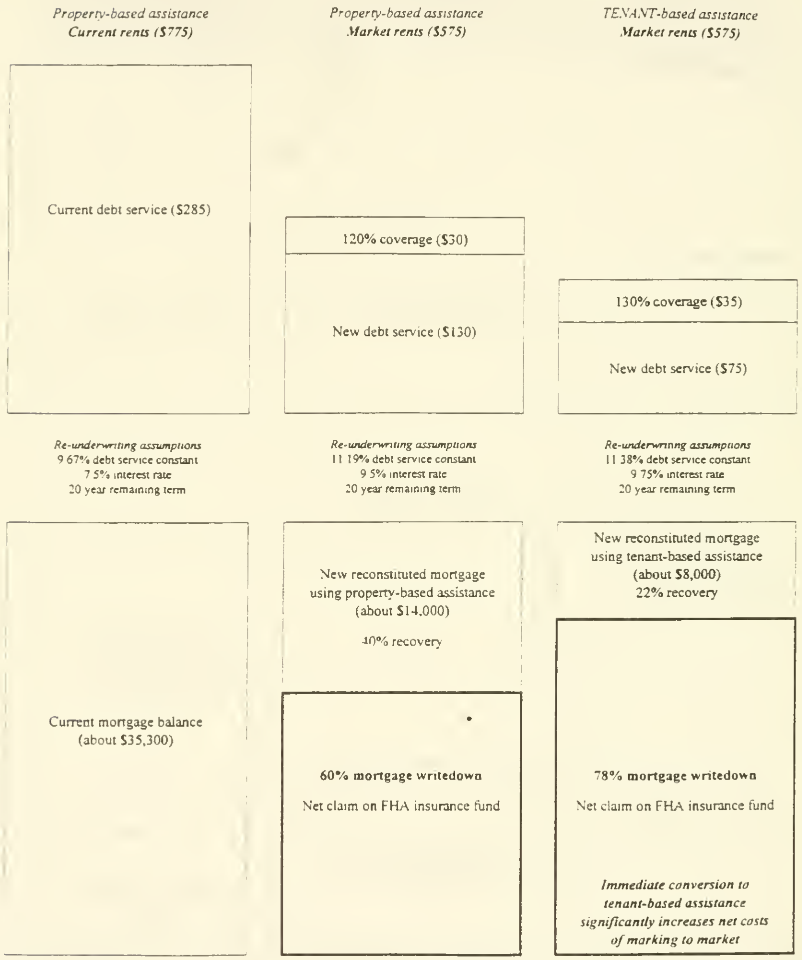
(Boxes reflect the proportion of monthly rent which must be dedicated to the specified use)



Marking Section 8 Rents to Market

Results of Re-underwriting: Mortgage Principal Writedown

(Boxes reflect the proportion of monthly rent which must be dedicated to the specified use)



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